Lending to the

Real Estate Industry

Presented by:

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I. Loan Documentation

A. INTRODUCTION

The typical commercial real estate loan is evidenced by the following documents: (i) promissory note; (ii) mortgage; (iii) assignments of rents; (iv) security agreement; and (v) if necessary, a personal guaranty.

B. PROMISSORY NOTES

A promissory note is a written legal document that obligates a borrower to repay a loan at a stated interest rate during a specified time period. In *Reves v. Ernst & Young*, 494 U.S. 56 (1990), the Supreme Court adopted a specialized test to determine whether a promissory note is a security interest. The Court held that the *Howey* investment contract test does not apply to promissory notes. Therefore, just because an instrument is not an investment contract does not mean it cannot be a promissory note for purposes of the Securities Exchange Act. *See* 15 U.S.C. § 78c(a)(10) (The term "security" includes any note with a maturity date exceeding nine months from the time of issuance.)

In determining whether an instrument denominated as a "note" is a "security," within the meaning of the Securities Exchange Act, the Supreme Court has said that courts should apply the "family resemblance" test. *Reves*, 494 U.S. at 66. Under the family resemblance test, a note is presumed to be a "security." *Id*. The presumption may be rebutted only by showing that the note bears a strong resemblance to one of the judicially crafted categories of instruments that are not securities. *Id*. This strong resemblance is determined by examining:

1. The transaction, to assess the motivations that would prompt a reasonable seller and buyer to enter into it;

2. The "plan of distribution" of the instrument, to determine whether it is an instrument in which there is common trading for speculation or investment;
3. The reasonable expectations of the investing public;[1] and
4. Whether some factor, such as the existence of another regulatory scheme, significantly reduces the risks inherent in the instrument, thereby rendering application of the Securities Acts unnecessary.

Id. If an instrument is not sufficiently similar to a listed item, the court must decide whether another category should be added by examining the same factors. *Id*. However, the phrase "any note" in section 78c(a)(10) of the Securities Exchange Act defining the term "security" should not be interpreted to mean literally "any note," but must be understood against the backdrop of what Congress was attempting to accomplish in enacting the statute. *Id*. at 62 – 63; 15 U.S.C. § 78c(a)(10).

A sample promissory note is included within the Appendix at Exhibit A.

C. MORTGAGES

The mortgage is the security document for real estate transactions. While some states use deeds in trust, Minnesota is a state in which a lender may obtain a lien on real estate by signing a mortgage.

1. Drafting the Mortgage

The basic elements of a mortgage are simply the owner's, or "mortgagor's," notarized signature, and a legal description of the real estate that is the subject of the mortgage. Additionally, a mortgage should also state the maturity date of the secured debt in the mortgage

[1] The court will consider instruments to be "securities" on the basis of such public expectations, even where an economic analysis of the circumstances of the particular transaction might suggest that the instruments are not "securities" as used in that transaction.

in order to avoid any potential problems with the statute of limitations. In negotiating a successful mortgage, however, there are some additional considerations.

Lenders negotiating a mortgage can avoid a costly and lengthy foreclosure by ensuring that the mortgage contains a "power of sale" clause. A power of sale clause gives the lender the right to foreclose the mortgage by advertisement or publication. With a power of sale clause, the mortgagee can then sell the property at public auction. Without a power of sale clause, the mortgagee would have to force the sale of the property by seeking court action. A foreclosure by advertisement is much more desirable than a foreclosure by judicial action.

If a mortgage secures a revolving line of credit, the parties negotiating the mortgage should be sure to express this in the language of the mortgage itself. Drafters should also include language that states the maximum principal amount that the mortgagor will be securing at any given time.

Finally, in negotiating a mortgage, drafters should also consider that the lender's mortgage may not be a first mortgage. If this is the case, lenders should be sure to record a "request for notice" in order to receive notice on any foreclosure of a senior mortgage.

2. Perfecting the Mortgage

After the mortgage is drafted it must also be perfected. In order to perfect a mortgage, the mortgage must be recorded in the county real estate files. Minnesota law limits the secured party's priority in some statutorily protected areas such as possessory liens and mechanic's liens, among others. *See* Minn. Stat. § 336.9-317-38 (on priorities). More often, however, once a mortgage is recorded, it gives a lender priority over a later filed mortgage, lien, or interest.

a. Superpriority Status

The rules and regulations governing secured transactions in real property are codified in Article 9 of the Uniform Commercial Code ("UCC"). Revised Article 9 has been adopted in all fifty states and the District of Columbia, and became effective in Minnesota on July 1, 2001. Regarding priority, revised Article 9 is similar to the former Article 9 and holds that purchase money security interests enjoy superpriority status. In *Maplewood Bank & Trust v. Sears, Roebuck & Co*., 625 A.2d 537 (N.J. 1993), the court held that under the former language of Article 9, a fixture financier with a purchase money security interest in kitchen appliances was entitled to priority over a prior mortgagee. Even though the fixture security interest came after the real estate mortgage security interest, it was entitled to superpriority because it was a purchase money security interest and was properly perfected. However, even with this superpriority status, the court further held that, in the event of a mortgage foreclosure sale, Sears would not be entitled to any of the sale proceeds. Its only option would be to remove the fixtures and to pay for any repairs caused by the removal. Under revised Article 9, the court would likely reach the same result, holding that purchase money security interests retain this superpriority status and are entitled to this same limited remedy.

b. Mortgage Registration Taxes

Minnesota has a mortgage registration, or "registry," tax that must be paid when the mortgage is recorded. The tax rate is .0023 of the portion of debt secured by the mortgage. Minn. Stat. § 287.035 (2006). Although the tax must be paid, the lender should take care when revising the mortgage, because if the lender is not increasing the mortgage debt, but is merely amending a mortgage, the lender can avoid paying more tax by inserting a revised statutory legend on the first page of the mortgage.

A sample mortgage is included within the Appendix at Exhibit B.

D. ASSIGNMENT OF RENTS AND RELATED DOCUMENTS

1. Assignment of Rents

An assignment of rents, or "lease," is an agreement whereby the landlord of a lease assigns the rights to rent under that lease to another party. Minnesota permits assignments of rents and profits by mortgagors to serve as additional security for a debt, so long as: 1) the mortgage was executed, modified or amended after August 1, 1977; 2) the mortgage secured an original principal amount of $100,000 or more, and; 3) the mortgage is *not* a lien upon property which was entirely homesteaded as agricultural property or residential property with fewer than four dwelling units. Minn. Stat. § 559.17 subd. 2 (2006).

In Minnesota, an assignment of rent can either be included with a mortgage or it can exist as a separate document. Many lenders prefer a separate document because an assignment can be enforced even in the event that a foreclosure sale extinguishes all or part of the mortgage debt. *See* 6A Minn. Prac. § 48.16. Even if the assignment of rent is a separate document, it may be easier to enforce if the lender also has a mortgage. For example, Minnesota Statute section 559.17, subdivision 2(3)(ii)(b) provides an enforcement mechanism for the assignment of rents in the event of a default in the terms and conditions of a mortgage. If such a default occurs, the assignment of rent may be enforced by filing a notice of default with the county recorder, and serving a copy of the notice on the occupants of the premises. Although this may not be desirable as a permanent arrangement, in that it will not allow the holder to control the premises, it will at least compel the occupiers of the premises to pay rent directly to the holder. Without a default on an accompanying mortgage, however, this option of enforcement by notice will not

work. It is likely the lender would instead have to apply for a court-appointed receiver in order to enforce the assignment of rent.

2. Security Agreements

Most real estate loan transactions involve some form of security agreement. A security agreement is an agreement in which the debtor transfers his or her security interest in the collateral to the secured party, such as the lender, in order to guarantee the debtor's payment. With a security interest, the lender obtains a legal interest in the debtor's collateral. Successfully creating an enforceable security interest requires the formation and perfection of a security agreement.

Under UCC Article 9, in order for the security agreement to be valid and enforceable, it must contain (1) the debtor's signature, which has been replaced by the term, "authentication" to permit for e-signatures, and (2) a sufficient description of the collateral. UCC § 9-203(b)(3)(A).

In addition to the debtor's signature and a collateral description, the courts have also interpreted a valid security agreement to require language creating a security interest. In *Stringer v. Mitchell,* 261 B.R. 680, 44 U.C.C. Rep. Serv. 2d (West) 921 (Bankr. D. Or. 2001), the court held that a security interest was *not* created by the lender and debtor's agreement. Although their financing statement contained an adequate description of the collateral, it did not contain any language which would actually create or provide for the security interest. Thus, a financing statement alone will not suffice, additional language is needed creating an express security interest in the collateral.

A sample security agreement is included within the Appendix at Exhibit C.

3. Exotic Agreements

In addition to the assignment of rents, mortgages, and security agreements, circumstances may sometimes give rise to the need for other stand-alone agreements. These agreements are more exotic than standard security documents, and work to better tailor the transaction to the parties' needs. One example of such an agreement may be a "voluntary foreclosure agreement." A voluntary foreclosure agreement may be appropriate, for instance, when the entire security agreement is part of a workout. These agreements can be used, however, whenever the lender believes that he is not adequately secured.

More commonly, parties may look to negotiate an exotic agreement when cash is a substantial component of the security agreement. For example, when the borrower is a business that tends to handle a lot of cash, the lender may seek an agreement that protects that cash. Under such circumstances, a standard security agreement may not provide the kind of protection that a lender seeks. Instead, a depository agreement, like a disbursement agreement, provides the desired protection.

A classic example of a borrower with whom a lender may wish to negotiate a depository agreement is a casino. In a casino setting, the customers tender large amounts of cash. Under a depository agreement, the lender could require that the casino's daily intake of cash actually goes to a third party—usually an accountant or accounting firm. The accounting firm would then draw on the cash deposits to issue checks to vendors, employees, and the like. Importantly, this arrangement would also provide a way for lenders to ensure that the borrower's cash is used to satisfy any secured obligations.

E. PERSONAL GUARANTY

When the borrower is an entity, a lender usually requires a personal guaranty from each owner of the entity. A personal guaranty is a form of security agreement which obligates the guarantor to perform the borrower's obligations when the borrower cannot perform. The collateral for the guaranty is the guarantor's personal assets, including the guarantor's home. In the event that the entity borrower files for bankruptcy, a lender can still enforce any personal guaranty to recover any amount owed.

Section I Appendix

Exhibit A – Sample Promissory Note

PROMISSORY NOTE

________,2006 $____________

A. **FOR VALUE RECEIVED**, __________ a Minnesota corporation ("Borrower"), as maker, promises to pay to the order of _________________, a Minnesota limited liability company (hereinafter "Lender") at (address) _________________or at such other place as the holder of this Promissory Note ("Note") may designate, the principal sum of ________________and no/100ths Dollars ($_____________) ("Principal Amount") together with interest accruing at a rate of ________ percent (___%) per annum, until all principal and interest is paid in full pursuant hereto ("Interest"). Interest shall be computed on the basis of the actual days elapsed in a year consisting of 360 days. Notwithstanding the foregoing, the outstanding Principal Balance and any accrued but unpaid Interest shall be payable in full on or before _______________, 2006 ("Due Date"). **The Payment then due is a balloon payment.** Proceeds of the balloon payment shall be distributed as follows: _____________________ and no/100ths Dollars ($_______) shall be delivered in certified funds to ____________________ to be applied to the account of Lender, and the remainder shall be delivered in certified fund to the Lender.

This Note may be prepaid in full or in part at any time without penalty. All payments shall be applied first to any fees or other costs recoverable hereunder and thereafter to the reduction of the principal amounts advanced by Lender.

An Event of Default shall mean and include for the purposes of this Promissory Note any one or more of the events as follows: (1) Borrower shall fail to pay, when due, any amount due and payable under this Promissory Note and shall fail to cure such default within ten (10) days after receiving from Lender a written notice of such default; or (2) there shall have been filed or commenced against Borrower an involuntary case under any applicable bankruptcy, insolvency or other similar laws now or hereafter in effect or an action shall have been commenced to appoint a receiver, liquidator, assignee, custodian, trustee, sequestrator (or similar official) of Borrower or for any substantial part of Borrower's property or for the winding-up or liquidation of Borrower's affairs and such action or proceeding shall not have been dismissed within sixty (60) days; or (3) Borrower shall commence a voluntary case under any applicable bankruptcy, insolvency or other similar laws now or hereafter in effect; or shall consent to the entry of an order for relief in an involuntary case under any such law; or shall consent to the appointment of or taking possession by a receiver, liquidator, assignee, trustee, custodian, sequestrator (or other similar official) of Borrower or of any substantial part of Borrower's property; or shall make any general assignment for the benefit of creditors; or shall take any action in furtherance of any of the foregoing.

Upon the occurrence of an Event of Default, Lender may, at Lender's option, declare the entire unpaid Principal Amount and any accrued Interest thereon immediately due and payable upon written notice to Borrower.

Borrower shall abstain from and shall not cause or permit any sale, conveyance, transfer or other disposition of this Promissory Note or the property and assets secured thereby. Any consent by Lender to any transfer hereunder is within Lender's sole discretion and Lender shall have the right to elect, in its sole discretion, any one or more of the following: (1) to declare the entire unpaid Principal Amount, together with accrued but unpaid Interest thereon, immediately due and payable; (2) to require a modification of the Interest rate; (3) to require a payment of a portion of the outstanding indebtedness on the Principal Amount; and/or (4) to require the payment of an assumption fee.

The makers, endorsers, sureties, guarantor, Borrower, and other persons liable for all or any part of the Principal Balance evidenced by this Note severally waive presentment for payment, demand, notice of dishonor, protest, notice of protest, diligence of collection, notice of non-payment, and any other notice of any kind, and hereby consent to any number of renewals and extensions of time of payment hereof which renewals and extensions shall not affect the liability of any party hereto. Such parties further agree that Lender may accept, by way of compromise or settlement, from any one or more of the parties liable hereunder a sum or sums less than the amount of this Note, and may give releases to such parties without affecting the liability of any other party for the unpaid balance. Any such renewals or extensions may be made and any such partial payments accepted or releases given without notice to any such party.

Borrower hereby waives and releases all errors, defects and imperfections in any proceedings instituted by Lender under the terms of this Note, as well as all benefit that might accrue to Borrower by virtue of any present or future laws, from attachment, levy or sale under execution, or provided for any stay of execution, exemption from civil process, or extension of time for payment. Borrower agrees that any real estate that may be levied upon pursuant to a judgment obtained by virtue hereof, or upon any writ of execution issued thereon, may be sold upon any such writ in whole or in part in any order desired by Lender, unless otherwise provided pursuant to Minnesota Statutes.

The word "Borrower" whenever used herein is intended to and shall be construed to mean the persons or entities who have executed this Note, and their heirs, legal representatives, successors and assigns, and the liability of each person or entity named as Borrower shall be joint and several. All covenants, promises, agreements, authorizations, waivers, releases, options, undertakings, rights and benefits made or given herein by Borrower shall bind and affect all persons who are hereinabove defined as "Borrower" as fully as though all such persons were specifically named herein whenever the term "Borrower" is used. Whenever used, the singular number shall include the plural, the plural the singular, and the use of any gender shall be applicable to all genders.

Borrower hereby consents to the exclusive jurisdiction of the Courts of the State of Minnesota in any and all actions or proceedings arising hereunder or pursuant hereto, and irrevocably agrees to service of process pursuant to Minnesota Statutes to its address set forth herein or such other address as Borrower may direct by written notice to Lender.

BORROWER IRREVOCABLY AS AN INDEPENDENT COVENANT WAIVES A JURY TRIAL AND THE RIGHT THERETO IN ANY ACTION OR PROCEEDING BETWEEN BORROWER AND LENDER WHETHER HEREUNDER OR OTHERWISE.

This Note may not be changed orally, but only by an agreement in writing signed by Borrower and Lender.

If any provision of this Note or the application thereof is held by a court of competent jurisdiction to be invalid or unenforceable, the remaining provisions hereof shall not be affected thereby, and each provision of this Note shall be valid and enforceable to the fullest extent permitted by law.

All notices and other communications required under this Note shall be given at the addresses first noted above.

This Note shall be secured by (i) the personal guaranty of ____________ of even date herewith the terms and provisions of which are incorporated herein by reference (the "Guaranty"); (ii) a Second Mortgage in favor of Lender; and (iii) a security interest in and to any and all furnishings, fixtures and equipments of Borrower and/or its successors and assigns, and located within the property legally described within the Combination Mortgage, Security Agreement and Fixture Financing Statement ("Mortgage"). Borrower hereby acknowledges and agrees that any default arising with respect to any of the Note, the Guaranty, the Mortgage or any other contemporaneous documentation of even date herewith by and between Borrower and Lender (collectively the "Agreements") shall be deemed to be a default with respect to all of the Agreements.

IN WITNESS WHEREOF, Borrower has executed this Note as of this ____ day of ______________, 2006 to be effective as of the day and year first above written on this Note.

By: ______________________________

Its: ______________________________

Exhibit B – Sample Mortgage

MORTGAGE

This Mortgage ("Mortgage"), made this ____ day of _________, 2006 by _______________________ and _________________________________, ("Mortgagor"), to _________________________ a _______________________________________, ("Mortgagee");

WITNESSETH THAT, in consideration of the sum of __________________ Dollars ($_________) to them in hand paid by Mortgagee, the receipt of which is hereby acknowledged, Mortgagors do hereby grant, bargain, sell, and convey unto Mortgagee, forever: (a) the tracts or parcels of land described in Exhibit "A" attached hereto and made part hereof (hereafter sometimes called the "Land"); (b) all of the buildings, structures, and other improvements now standing or at any time hereafter constructed or placed upon the Land (hereafter sometimes called the "Improvements"); (c) all fixtures (the "Fixtures") and all personal property (the "Personal Property" owned by Mortgagors and located on or used in connection with the Land or the Improvements; (d) all extensions, additions, improvements, betterments, renewals and replacements of any of the foregoing, and (e) all hereditaments, easements, rights, privileges and appurtenances now or hereafter belonging, attached or in any way pertaining to the Land or to any of the Improvements (all of the foregoing are hereafter referred to as the "Mortgaged Property").

TO HAVE AND TO HOLD the Mortgaged Property unto Mortgagee forever.

PROVIDED, NEVERTHELESS, that if Mortgagors shall pay to Mortgagee according to the terms of that certain Promissory Note of even date herewith made by Mortgagors to the order of Mortgagee in the stated principal amount of _______________ Dollars ($____________)(the "Note"), all of the terms of which are hereby made a part of this Mortgage to the same extent and with the same effect as if they were fully set forth herein, and shall also pay all other sums, with interest thereon, as may be advanced by Mortgagee in accordance with this Mortgage to protect the lien of this Mortgage, and shall also keep and perform all and singular the covenants herein and in the Note contained on the part of Mortgagors to be kept and performed (all such debts and obligations being hereafter sometimes called the "Indebtedness"), then this Mortgage shall be null and void, in which event the Mortgagee will execute and deliver to Mortgagors, in form suitable for recording, a full release of this Mortgage; otherwise, this Mortgage shall remain in full force and effect.

Mortgagors represent, warrant, and covenant to and with Mortgagee that they are lawfully seized of the Mortgaged Property in fee simple unless otherwise expressly limited and have the right and lawful authority to mortgage the same as provided herein; that the Mortgaged Property is free from all liens and encumbrances except as otherwise disclosed to Mortgagee in writing (the "Permitted Encumbrances"); that all Improvements now or hereafter located on the Land are, or will be, located entirely within the boundaries of the Land; that Mortgagors will warrant and defend the title to the Mortgaged Property against all claims and demands whatsoever not specifically excepted herein; and that there is no hazardous substance as defined

in Minnesota Statutes Section 11 5B.02, Subdivision 8, located anywhere in or on the Mortgaged Property, nor any facility as defined in Minnesota Statutes Section 115B.02, Subdivision 5(c), located in or on the Mortgaged Property.

Article I

Covenants of Mortgagors

Mortgagors further covenant and agree as follows:

1.01 Insurance. Mortgagors will keep the Improvements, Fixtures, and Personal Property now existing or hereafter erected or placed on the Land insured against loss by fire, perils of extended coverage, and such other hazards, casualties, and contingencies as Mortgagee shall designate for the full replacement cost thereof with policies in such form as may be required by Mortgagee. All insurance shall be carried in companies approved by Mortgagee and the policies and renewals thereof shall (a) contain a waiver of defense based on coinsurance, (b) be constantly assigned and pledged to and held by Mortgagee as additional security for the Indebtedness, and (c) have attached thereto loss payable clauses in favor of and in from acceptable to Mortgagee. In event of loss, Mortgagors will give immediate notice by mail to Mortgagee, who may make proof of loss if not made promptly by Mortgagors. Mortgagors hereby authorize Mortgagee to settle and compromise all claims on such policies and hereby authorizes and directs each insurance company concerned to make payment for any such loss directly to Mortgagee. The insurance proceeds, or any part thereof, may be applied to Mortgagee at its option either to payment of the Indebtedness, and if the proceeds are not sufficient to pay the entire Indebtedness, then to reduction of the Indebtedness by applying to installments in the inverse order of their maturity, regardless whether such installments are then due and payable, or to the restoration or repair of the property damaged. In the event of foreclosure of this Mortgage, all right, title, and interest of Mortgagors in and to any insurance policies then in force and proceeds of insurance not yet paid for loss or damage shall pass to the purchaser at the foreclosure sale.

1.02 Monthly Installments of Taxes and Insurance Premiums and Reserve for Maintenance. Mortgagors shall pay, together with and in addition to each monthly installment required by the Note, an amount estimated by Mortgagee to be sufficient to enable Mortgagee to pay, at least 30 days before due, all premiums for insurance required by Section 1.01 hereof and, at least 30 days before penalty attaches, all taxes, assessments, and other similar charges against the Mortgaged Property. Mortgagors shall also pay, if demanded by Mortgagee and provided Mortgagee has reason to believe that the Mortgaged Property in not being cared for as required below, in addition to each monthly installment required by the Note, an amount estimated by Mortgagee to be sufficient to enable Mortgagors to maintain the Mortgaged Property as required below. Such added payments shall not be, nor be deemed to be, trust funds, but may be commingled with the general funds of Mortgagee and no interest shall be payable thereon. Upon demand of Mortgagee, Mortgagors will deliver to Mortgagee such additional monies as are necessary to make up any deficiency in the amount necessary to enable Mortgagee to pay the
foreclosing. In the event of a default by Mortgagors in the performance of any of the terms, covenants, or conditions herein or in the Note, Mortgagee may apply on the Indebtedness, in

such manner as Mortgagee shall determine, any funds of Mortgagors then in Mortgagee's possession under this section. Mortgagors will pay promptly, when due, any insurance premiums and, before penalty attaches, any taxes, assessments, and similar charges, payment for which has not been provided as hereinbefore contemplated.

1.03 Payment of Utility Charges. Mortgagors shall pay or cause to be paid all charges for electricity, gas, heat, water, and sewer furnished or used in connection with the Mortgaged Property and will, upon request by Mortgagee, furnish proper receipts showing such payment.

1.04 Liens. Except for the Permitted Encumbrances, Mortgagors will keep the Mortgaged Property free from all liens, encumbrances, and security interests of every nature heretofore or hereafter arising. No fixtures will be installed subject to vendor's lien or other lien. Should any fixture be installed, the lien of this Mortgage shall immediately attach and be prior and superior to all other liens or claims. Mortgagors shall pay all amounts and perform all obligations required pursuant to any Permitted Encumbrances and shall not permit any default to occur thereunder.

1.05 Care of Property. Mortgagors will take good care of the Mortgaged Property, and will maintain the same in as good repair and condition as existed at the date of this Mortgage, ordinary depreciation excepted, and will commit or permit no waste, and will not construct any new Improvements on the Land nor add to or alter the design or structural character of any of the Improvements without the prior written consent of Mortgagee, and will not remove or permit removal of any Improvements, Fixtures, or Personal Property of any kind from the Land nor do any act that would impair or lessen the value of the Mortgaged Property without the prior written consent of Mortgagee. Mortgagors will promptly comply with all present and future laws, ordinances, rules, and regulations of any governmental authority affecting the Mortgaged Property.

1.06 Change in Tax Laws. Mortgagors will pay all taxes, assessments, and other similar charges, other than Mortgagee's income tax, which may be assessed upon the Mortgaged Property, or upon Mortgagee's interest therein, or upon this Mortgage or the monies secured hereby without regard to any law heretofore enacted or hereafter to be enacted, imposing payment of the whole or any part thereof upon Mortgagee. Upon violation of this undertaking or the passage of a law imposing payment of the whole or any portion of any taxes aforesaid upon Mortgagee, or upon the rendering by any court of competent jurisdiction of a decision that the undertaking by Mortgagors as herein provided to pay any taxes, assessments, or other similar charges is legally inoperative, then and in any such event the Indebtedness, without any deduction, shall at the option of Mortgagee become immediately due and payable, notwithstanding anything contained in this Mortgage or any law hereafter enacted.

1.07 Condemnation. If all or any part of the Mortgaged Property is damaged, taken, or acquired, either temporarily or permanently, in any condemnation proceeding or by exercise of the right of eminent domain, or by conveyance in lieu thereof, the amount of any award or other payment for such taking, acquisition, or damages made in consideration thereof, to the extent of the full amount of the remaining Indebtedness, is hereby assigned to Mortgagee, who is empowered to collect and receive the same and to give proper receipts therefor in the name of

Mortgagors, and the same shall be paid forthwith top Mortgagee, who at its option may release any such award or moneys so received or apply the same, in whole or in part, after the payment of all of its expenses, including costs and attorneys' fees, to payment of the Indebtedness, and if the proceeds are not sufficient to pay the entire Indebtedness, then to reduction of the Indebtedness by applying to installments in the inverse order of their maturity, regardless whether such installments are then due and payable.

1.08 Subrogation. If Mortgagee pays any prior lien from the proceeds of the loan evidenced by the Note, it shall be subrogated to the rights of the holder of such prior lien as fully as if such lien had been assigned to Mortgagee.

1.09 Miscellaneous Rights of Mortgagee. Mortgagee may at any time and from time to time, without notice, release any person liable for payment of any of the Indebtedness, extend the time or alter the terms of payment of any of the Indebtedness, accept additional security of any kind, release any property securing the Indebtedness, consent to the making if any plat or map of the Land or the creation of any easement thereon or any covenants restricting the use or occupancy thereof, or alter or amend the terms of this Mortgage in any way. No such release, modification, addition, or change shall affect the liability of any person other than the person so released for payment of the Indebtedness, nor affect the priority and first lien status of this Mortgage upon any property not so released.

1.10 Right of Mortgagee to Perform. If Mortgagors fail to pay all and singular any taxes, assessments, or other similar charges heretofore or hereafter assessed against the Mortgaged Property or fail to obtain the release of any lien or encumbrance (other than the Permitted Encumbrances) of any nature heretofore or hereafter arising upon the Mortgaged Property or fail to perform any other covenants and agreements contained in this Mortgage or if any action or proceeding is commenced which adversely affects or questions the title to or possession of the Mortgaged Property or the interest of Mortgagors or Mortgagee therein, then Mortgagee at its option, without notice to Mortgagors, may perform such covenants and agreements, investigate and defend against such action or proceeding, and take such other action as Mortgagee deems necessary to protect Mortgagee's interest. Any amounts disbursed by Mortgagee pursuant to this section, including court costs and expenses and attorneys' fees, shall become additional Indebtedness of Mortgagors secured by this Mortgage. Such amounts shall be payable upon notice from Mortgagee to Mortgagors requesting payment thereof, and shall bear interest from the date of disbursement at the rate applicable to the principal provided in the Note. Nothing contained in this section shall require Mortgagee to incur any expense or to do any act hereunder.

1.11 Transfer of Mortgaged Property. Mortgagors may not sell, assign, convey, or mortgage the legal or equitable title or both legal and equitable title to all or any portion of the Mortgaged Property without the written consent of Mortgagee. If Mortgagor is a corporation, partnership, or other entity, the legal, beneficial, or equitable ownership of such entity shall not be changed by sale, conveyance, transfer, assignment, or encumbrance without the written consent of Mortgagee.

Article II

Default

2.01 Event of Default Defined. Each of the following occurrences shall constitute an Event of Default hereunder ("Event of Default"):

a. Mortgagors shall fail to pay when due the principal sum of the Note or any interest thereon or any installment thereof or shall fail to pay when due any subsequent loan or advance made by Mortgagee hereunder or the interest thereon or shall fail to perform any of the other covenants or agreements of Mortgagors in the Note;

b. Mortgagors shall fail duly to perform or observe any of the covenants contained in this Mortgage; or

c. Any representation or warranty made by Mortgagors in this Mortgage is untrue or misleading in any material respect, or any statement, certificate, or report furnished hereunder by or on behalf of Mortgagors is untrue or misleading in any material respect on the date as of which the facts set forth are stated or certified.

2.02 Remedies. Upon the occurrence of an Event of Default or at any time thereafter until such Event of Default is cured to the satisfaction of Mortgagee, Mortgagee may at its option exercise any or all of the following rights and remedies (and any other rights and remedies now or then available to it, either hereunder or at law or in equity, including, without limitation, the rights and remedies provided in Section 1.08 hereof):

a. Mortgagee may, without notice to Mortgagors, declare immediately due and payable all of the Indebtedness, and the same shall thereupon be immediately due and payable; and

b. Mortgagee may foreclose this Mortgage by action or advertisement, and Mortgagors hereby authorize Mortgagee to do so, power being herein expressly granted to sell the Mortgaged Property at public auction without any prior hearing or notice thereof and to convey the same to the purchaser, in fee simple, pursuant to the statutes of Minnesota in such case made and provided and out of the proceeds arising from such sale, to pay all Indebtedness with interest, and all legal costs and charges of such foreclosure and the maximum attorneys' fees permitted by law, which costs, charges, and fees Mortgagors agree to pay. In the event of a sale under this Mortgage, whether by virtue of judicial proceedings or otherwise, the Mortgaged Property may, at the option of Mortgagee, be sold as one parcel and as an entirety or in such parcels, manner, and order as Mortgagee in its sole discretion may elect.

ARTICLE III

Miscellaneous

3.01 No Implied Waiver. Any delay by Mortgagee in exercising or any failure by Mortgagee to exercise any right or remedy hereunder or afforded by law shall not be a waiver of

nor preclude the exercise of any right or remedy hereunder, whether on such occasion or any future occasion.

3.02 Remedies Cumulative. Each remedy of Mortgagee is distinct and cumulative to each other right or remedy under this Mortgage or afforded by law and may be exercised concurrently or independently. Foreclosure of this Mortgage will not affect or limit any right or remedy of Mortgagee on account of any breach by Mortgagors of the terms of this Mortgage occurring prior to such foreclosure.

3.03 Successors and Assigns. The rights hereunder shall inure to the successors and assigns of Mortgagee. The term "Mortgagors" shall be deemed to include heirs, devisees, personal representatives, successors, and assigns of Mortgagors, including any purchasers or transferees of the Mortgaged Property or any interest therein.

3.04 Addresses. The address of Mortgagee, from which information concerning the security interest hereby granted may be obtained, is as follows:

The mailing address of Mortgagors is as follows:

Any notice, request, demand, or other communication permitted or required hereunder shall be in writing and shall be deemed duly given if deposited in the United States mails, first class postage prepaid, addressed to the party for whom intended at the address specified above or at such other address as either party shall have notified the other.

3.05 Headings. The headings of the sections contained herein are for convenience only and are not to be construed to be a part of or limit or affect the terms hereof.

3.06 Waiver of Rights Regarding Remedies. Mortgagor understands and agrees that if an "Event of Default" (as defined in Section 2.01 of this Mortgage) shall occur, Mortgagee has the right, among others, to foreclose this Mortgage by advertisement pursuant to applicable State law as now in effect or as it may be hereafter amended.

Mortgagor further understands that in the event of such default Mortgagee may take possession of any personal property covered by this Mortgage and dispose of the same by sale or otherwise in one or more parcels, provided that at least 10 days' prior notice of such disposition be given to Mortgagor, all as provided for by the Uniform Commercial Code, as now in effect or as hereafter amended, or by any similar or replacement statute hereafter enacted. -

Mortgagors further understand that under the Constitutions of the United States and the State of Virginia they may have the right to notice and hearing before the Mortgaged Property may be sold and that the procedure for foreclosure by advertisement described above does not insure that notice will be given to Mortgagors, and neither said procedure for foreclosure by

advertisement nor the Uniform Commercial Code requires any such hearing or other judicial proceeding.

Mortgagors hereby relinquish, waive, and give up their constitutional rights, if any, to notice and hearing before sale of the Mortgaged Property and expressly consent and agree that the Mortgaged Property may be foreclosed by advertisement and that personal property covered by this Mortgage may be disposed of pursuant to the Uniform Commercial Code, all as described above.

3.07. Severability and Survival. The unenforceability or invalidity of any provision or provisions of this Mortgage as to any persons or circumstances shall not render that provision or those provisions unenforceable or invalid as to any other persons or circumstances, and all provisions hereof, in all other respects, shall remain valid and enforceable.

Mortgagors have executed this Mortgage as of the day and year first-above written.

STATE OF MINNESOTA)
)ss.
COUNTY OF ____________)

The forgoing instrument was acknowledged before me this _____ day of _________, 2006, by ___________________________, a ____________.

Notary Public

Exhibit C – Sample Security Agreement

SECURITY AGREEMENT

____________________________________, whose address is _____________________ _________________________________ in the County of _____________, State of Minnesota (hereinafter called "Debtor") do hereby grant unto _______________________ a ___________________, whose address is _____________________________, in the County of ____________, State of Minnesota, (hereinafter called "Secured Party"), a security interest in the following property (hereinafter called "Collateral"):

a. All inventory of the Debtor, and all returns of such inventory, and all warehouse receipts, bills of lading and other documents of title covering such inventory, whether now existing or hereafter existing, whether now owned or hereafter acquired;

b. All equipment of the Debtor, including, but not limited to, all present and future machinery, vehicles, furniture, fixtures, manufacturing equipment, farm machinery and equipment, shop equipment, office and recording equipment, parts and tools and the goods described in any equipment schedule or list herewith or hereafter furnished to secured party by Debtor (but no such schedule or list need be furnished in order for the security interest granted herein to be valid as to all of Debtor's equipment), together with all accessions, accessories, attachments, fittings, increases, parts, repairs, returns, renewals and substitutions of all or any part thereof, and all warehouse receipts, bills of lading and other documents of title covering such equipment, whether now existing or hereafter arising, whether now owned or hereafter acquired;

c. All accounts, instruments, chattel paper, investment property, letters of credit, other rights to payment, documents, deposit accounts, money, patents, patent applications, trademarks, trademark applications, copyrights, copyright applications, trade names, other names, and other general intangibles of the Debtor, together with all rights, liens, security interests and other interests which the Debtor may at any time have by law or agreement against any account debtor, issuer or obligor obligated to make any such payment or against any of the property of such account debtor, issuer, or obligor, whether now existing or hereafter arising, whether now owned or hereafter acquired; and

d. All products and proceeds of the foregoing property, including without limitation all accounts, instruments, chattel paper, investment property, letters of credit, other rights to payment, documents, deposit accounts, money, insurance proceeds and general intangibles related to the foregoing property, and all refunds of insurance premiums due or to become due under all insurance policies covering the foregoing property.

The Collateral shall include (i) all substitutions and replacements for and proceeds of any and all of the foregoing property, and in the case of all tangible Collateral, all accessions, accessories, attachments, parts, equipment and repairs now or hereafter attached or affixed to or used in

connection with any such goods, and (ii) all warehouse receipts, bills of lading and other documents of title now or hereafter covering such goods to secure prompt payment to Secured Party at the address stated above of a Loan Note in the principal amount of _________________ and no/l00 Dollars ($_______.00), of even date herewith, and to secure performance of all obligations owed by Debtor to Secured Party under the Loan Note of even date herewith and the Loan Note between Debtor and Secured Party in the original principal amount of ________________ and no/100ths Dollars ($_______.00), including any modifications, extensions, renewals, or future advances made by Secured Party to Debtor at Secured Party's option, together with all other liabilities of Debtor to Secured Party (primarily, secondarily, direct, contingent, sole, joint, or several) due or to become due or which may be hereafter contracted or acquired and the performance by Debtor of all the terms and conditions of this Security Agreement (hereinafter referred to as "Obligations").

DEBTOR WARRANTS, REPRESENTS AND AGREES THAT:

1. Debtor is the owner of the Collateral, or will be the owner of the Collateral to. be acquired after the date hereof; free of all liens, encumbrances and security interests except the security interest hereby created and has authority to execute this Agreement. Debtor's interest in the Collateral is genuine and enforceable and there are no offsets, counterclaims, or defenses to any of it.

2. Debtor's inventory, books, records, contract rights and other property above specified relating to the Collateral are 'or will be kept at the above address unless a different address is noticed to Secured Party by Debtor. Debtor shall not, without the prior written consent of Secured Party, remove or permit the same to be removed from the location or locations set forth above.

DEBTOR FURTHER WARRANTS, REPRESENTS AND AGREES THAT:

1. Debtor shall use the Collateral in a lawful manner' consistent with this Agreement and with the terms and conditions of any policy of insurance thereon.

2. Debtor shall keep the Collateral insured at all times against loss by fire and/or other hazards concerning which, in the judgment of the Secured Party, insurance protection is reasonably necessary, with a company or companies satisfactory to the Secured Party and in amounts sufficient to protect Secured Party against loss or damage to said Collateral and shall pay the premiums therefor; that such policy or policies of insurance will be delivered to and held by the Secured Party, together with loss payable clauses in favor of the Secured Party as its interest may appear, in form satisfactory to the Secured Party; and Secured Party may act as attorney for Debtor in obtaining, adjusting, settling and canceling such insurance and endorsing any drafts.

3. No financing statement covering the Collateral, or any part thereof; is on file in any public office.

4. Debtor shall at any time hereafter execute such financing statements and other instruments and perform such acts as the Secured Party may request to establish and maintain a valid security interest in the Collateral, and shall pay all costs of filing and recording.

5. Until Secured Party shall notify Debtor of the revocation of such power and authority, Debtor shall, at its own expense, endeavor to collect, as and when due, all of Debtor's accounts with regard to the Collateral, including the taking of such action with respect to such collection or the repossession of the goods as Debtor may deem advisable or as Secured Party may reasonably request. Debtor shall forthwith deliver all proceeds of such collections to Secured Party.

6. Debtor shall not compromise any of Debtor's accounts with regard to the Collateral without the prior written consent of Secured Party.

7. Debtor shall at all times keep accurate and complete records of the Collateral and permit Secured Party to inspect same and the Collateral at all reasonable times. Debtor shall, upon request of Secured Party, furnish to Secured Party such reports and statements as Secured Party may reasonably request with respect to the Collateral.

8. Secured Party may notify account debtors in regard to the Collateral of Secured Party's security interest, and that payment of all sums due or to become due shall be paid directly to Secured Party, and upon request of Secured Party, Debtor shall notify account debtors in regard to the Collateral of such security interest. Secured Party shall have the power to demand, receive and sue for all moneys or other proceeds due from said accounts, to endorse the name of Debtor on all commercial paper given in payment or part payment thereof; and to settle, adjust or compromise any claims or disputes as to said accounts.

9. Debtor shall keep and maintain the Collateral in good condition and will not sell, lease or otherwise dispose of the Collateral other than in the ordinary course of its business at prices constituting the then fair market value thereof.

10. Debtor shall be in default under this Agreement upon the happening of any of the following events: (a) nonpayment, when due, of any amount payable on any of the Obligations or failure to observe or perform any term hereof provided; (b) if any covenant, warranty or representation shall prove to be untrue in any material respect; (c) Debtor becomes insolvent or unable to pay its debts as they mature or makes an assignment for the benefit of creditors, or any proceeding is instituted by or against Debtor alleging that Debtor is insolvent or unable to pay debts as they mature; (d) entry of any judgment against Debtor; (e) dissolution, merger or consolidation, or transfer of a substantial part of the property of Debtor without prior notification to Secured Party; or (f) if Secured Party deems itself insecure for any reason.

11. The terms and conditions contained in this Security Agreement are incorporated by reference into the Loan Note and the Loan Note for ____________ and no/100ths Dollars ($_____.00) and any other Loan Documents of even date herewith. A default by Debtor of any terms and conditions of this Security Agreement, the Loan Note and the Loan Note for _____________ and no/100ths Dollars ($_____.00) and any other Loan Documents of even date

herewith, including any amendment thereto, shall constitute a default by Debtor of all agreements between the parties, and a default under this Security Agreement.

12. In the event of a default: (a) Secured Party shall have the right, at its option and without demand or notice, to declare all or any part of the Obligations immediately due and payable; (b) Secured Party may exercise, in addition to the rights and remedies granted hereby, all of the rights and remedies of a Secured Party under the Uniform Commercial Code or any other applicable law; (c) Secured Party may effect all necessary insurance, pay the premiums thereon, and may pay any taxes, liens and encumbrances on the Collateral, and any such payments made by Secured Party with interest at the highest legal rate allowed by law shall be a part of the Obligations; (d) Debtor agrees to make the Collateral available to the Secured Party at a place or places acceptable to the Secured Party; and (e) Debtor agrees to pay all costs and expenses of Secured Party, including reasonable attorneys' fees, in the collection of any of the Obligations or the enforcement of any of Secured Party's rights.

13. If any notification of intended disposition of any of the Collateral is required by law, such notification shall be deemed reasonably and properly given if mailed at least ten (10) days before such disposition, postage prepaid, addressed to the Debtor at the address shown herein.

14. Waiver of any default hereunder by Secured Party shall not be a waiver of any other default or of a same default on a later occasion. No delay or failure by Secured Party to exercise any right or remedy shall be a waiver of such right or remedy and no single or partial exercise by Secured Party of any right or remedy shall preclude other or further exercise thereof or the exercise of any other right or remedy at any other time.

15. This Agreement and all rights and obligations hereunder, including matters of construction, validity and performance, shall be governed by the laws of Minnesota. If any part of this contract shall be adjudged invalid, the remainder shall not thereby be invalidated.

16. All rights of Secured Party shall inure to the benefit of Secured Party's successors and assigns, and all obligations of Debtor shall bind Debtor's heirs, executors, administrators, successors and assigns.

Debtor:

Dated:_______, 200__

____
By: _______________________________________
Its:_______________________________________

Secured Party:

Dated: ______, 200__

____
By: _______________________________________
Its:_______________________________________

II. Due Diligence

A. Introduction

Once the purchase agreement is signed and purchaser applies for financing, the lender will begin its due diligence process on both the property and the purchaser. This section covers the most important due diligence items regarding the property being acquired. Due diligence for the lender is crucial as the property will be the most significant security for the repayment of the loan.

B. Lien Searches

Broadly defined, a lien is any encumbrance against an item of property that secures a debt or other obligation. At early common law the lien was a possesory right, meaning the lienholder had a right to retain possession of the property pending performance of the obligation. Modern liens generally no longer retain this possesory quality, but rather allow the lienholder a right to proceed against the property in order to recover on the obligation. Liens can be voluntarily created by contract, or involuntarily created through operation of law. Examples of involuntary liens include tax liens and judgment liens. A common voluntary lien is the Mechanic's Lien.

Federal tax liens are filed in the office of the county recorder of the county in which the property is located. State tax liens are recorded with the office of the secretary of state, and can be searched in the same manner as UCC records. Other liens are filed in either the office of the county recorder, the office of the secretary of state, or both. The title commitment, covered below, will indicate the existence of any lien shown by public records.

C. Title Commitment

The title commitment is the initial document issued by the title company that sets out the title company's conclusions as to the status of the title. The commitment also states the terms on

which the insurer will issue the final policy. The seller usually provides a title commitment to the purchaser within ten days of the execution of the purchase agreement. The title commitment will reveal to the lender if there are title issues that need to be corrected before closing and if there are title issues on which the lender may want to obtain additional title coverage.

The commitment consists of (1) a pre-printed cover, (2) Conditions and Stipulations of the contract between the underwriter and the customer, (3) Schedules A and B exceptions, and (4) all relevant attachments, such as easement maps or surveys.

1. Schedule A

Schedule A of the commitment sets forth basic information such as:

- The effective date of the commitment
- The estate or interest covered by the commitment
- The name of the vestee of the estate or interest
- A description of the land referred to in the commitment
- The name of the proposed insured
- The type and amount of each policy to be insured
- The title company's file number

2. Schedule B

Perhaps the most important component of the title commitment, Schedule B lists all exceptions to coverage under the policy. Exceptions are of two (2) types: general and special.

General exceptions usually appear on all commitments. There five standard general exceptions:

- rights or claims of parties in possession not shown by the public records
- encroachments, overlaps, boundary line disputes, and any other matters which would be disclosed by an accurate survey or inspection of the premises

- Easements, or claim of easements, not shown by the public records
- Any liens, or right to a lien, for services, labor, or material not shown by the public records
- Matters first occurring after the effective date of the policy and prior to the creation of the interest to be insured

Special Exceptions typically include items which must be addressed and corrected before issuance of the policy, or else the policy will exclude coverage of the items. Special exceptions often include:

- unpaid taxes or assessments
- existing mortgages
- adverse claims
- defects in description or vesting of title
- defective access or lack of access to property
- any other judgments, liens, easements, restrictions, covenants, conditions, or other encumbrances unique to the property

C. Zoning Letters

Zoning letters represent an important part of the real estate transactions process. A zoning letter is essentially a statement from the local municipal zoning authority (or other governmental body with jurisdiction over the property) indicating the current zoning classification for the property, and stating that the purchaser's intended use of the property is allowed under the current zoning classification.

In order to be assured of complete compliance with any zoning regulations, an attorney will need to determine which governmental body/ies have jurisdiction over the property, and whether there are any additional requirements for local approval of intended uses. Once the

attorney has determined which body/ies have jurisdiction, the attorney should acquire a zoning letter, zoning report, zoning certification or some other zoning document memorializing certain information. Regardless of the title of the document, the bottom-line requirement is to get a written statement from the zoning authority clearly describing the property and its current zoning classification, and confirming that such zoning classification specifically permits the purchaser's intended use of the property.

D. Environmental Assessments (Phase I and II)

Like a certificate of title, an environmental site assessment looks to past events to convey information regarding the present condition of the real estate. To this end, an environmental consulting firm should be hired to look for any past commercial or industrial activities or events that may have contaminated or otherwise affected the site. These searches are conducted through a "Phase I" environmental site assessment and a "Phase II" environmental site assessment.[2]

1. "Phase I" Environmental Assessment

The "Phase I" investigation is designed to reveal any potential for contamination on the site. In a "Phase I" investigation, an environmental consulting firm can provide an assessment of the activities of the property's prior owners. The assessment can also include a look at the activities of current and prior owners of neighboring cites. Typically, the Phase I assessment also involves a visual observation of the property, in an effort to observe any features that may point to the presence of potentially hazardous materials such as storage tanks or disposal zones. *See* 25 Minn. Prac. § 9.20(a).

[2] *See generally* ASTM E1527-05 "Standard Practice for Environmental Site Assessments: Phase I Environmental Site Assessment Process;" ATSM E1903-97 (2002) "Standard Guide for Environmental Site Assessments: Phase II Environmental Site Assessment Process." Available at www.astm.org, and a copy of which is included in the appendix.

The requirements of the assessment are flexible, and will vary with the circumstances. Real estate with a long history of industrial use will require a thorough and rigorous assessment, while a previously undeveloped site will require very little assessment. The purpose of the "Phase I" assessment is to determine whether the real estate is subject to recognized environmental conditions, i.e. the presence or likely presence of any hazardous substances or petroleum products on a property under conditions that indicate an existing release, a past release, or a material threat of a release of any hazardous substances or petroleum products into structures on the property or into the ground, ground water, or surface water of the property. As such, the process consists of the following:

- Property Records Review
- Visual Inspection
- Interviews with Current and Past Owners
- Interviews With Local Government Officials

If the Phase I assessment demonstrates any signs of contamination, the lender should engage the environmental consulting firm to perform a "Phase II" assessment.

2. "Phase II" Environmental Assessment

The primary objectives of conducting a Phase II assessment are to evaluate the recognized environmental conditions identified in the Phase I assessment for the purpose of providing sufficient information regarding the nature and extent of contamination to assist in making informed business decisions about the property; and where applicable, providing the level of knowledge necessary to satisfy the innocent purchaser defense under the Comprehensive Environmental Response, Compensation and Liability Act, ("CERCLA"). A Phase II assessment actually includes a physical inspection of the site, such as soil boring or groundwater

sampling, in an attempt to ascertain with more certainty whether contamination has occurred. *See* 25 Minn. Prac. § 9.20(a).

Again, the standards for a Phase II assessment are flexible and depend upon the scope of the users objectives. The mere confirmation of contamination or the preliminary indication of the extent and magnitude of contamination may be sufficient for the purposes of many users. If a user desires a more complete characterization of the environmental condition of the property, further assessment may be undertaken. Accordingly, the assessment may require multiple iterations, or may be subject to termination at the point where sufficient data have been generated. At the completion of a Phase II assessment, the environmental professional should be able to conclude, at a minimum, that either:

> *(a)* the assessment has provided sufficient information to render a professional opinion that there is no reasonable basis to suspect the presence of hazardous substances or petroleum products at the property associated with the recognized environmental conditions under assessment; or
>
> *(b)* the assessment has confirmed the presence of hazardous substances or petroleum products at the property under conditions that indicate disposal or release.

If the data generated is insufficient to support either of the above propositions, additional iterations of the assessment may be required.

The assessment is intended to identify recognized environmental conditions and develop technically sound data. It is not intended to satisfy the level of inquiry that may be necessary to support remedial solutions for a site.

E. Survey and Boundary Issues

A mortgage and a security agreement must contain a legal description of the real estate that secures the commercial loan. Where title insurance provides a legal description of the land, a survey is a different kind of insurance. A survey can be used to confirm that the legal

description of the real estate accurately depicts the real estate contemplated in the transaction. A survey can also provide a detailed account of existing conditions on the real estate.

The American Land Title Association ("ALTA") has set standards for surveys, as well as titles, and a surveyor's work generally conforms to these standards. The surveyor will address the most basic of issues, such as a boundary lines. The boundary line survey assures the lender that the structures securing their transactions are actually on the borrower's property. The surveyor will also address complicated issues, such as the conditions that exist on the property. With larger structures and properties, the lender will benefit from the survey's visual depiction of how municipal codes or ordinances have placed conditions on the real estate. For example, the survey may be able to reveal conditions on setbacks, parking spaces, or utilities more accurately and clearly than a legal, textual description. Other conditions that are important to be aware of are the existence and location of any easements or riparian interests on the property. The surveyor should draw attention to all such conditions.

Once the survey is complete, the attorneys should compare the survey with the legal descriptions of the real estate. Specifically, the attorneys should look for any ambiguous or erroneous legal descriptions. The attorney will also want to assess whether there are any conditions that may prevent the buyer from conducting their intended business. The diligent lawyer should also become aware of any prior surveys on the real estate, and check to see whether prior surveys conflict with the present survey.

In attending to the red tape, the survey certification form should be checked to ensure that it is addressed to all required parties, that it is signed, current, and in the required form. Finally, the survey certification form should be attached to the current title commitment.

While a survey may be relied upon even if it contains errors, there is a two-year statute of limitations on survey errors, except for where fraud is involved. Minn. Stat. § 541.052. Attorneys will also want to maintain the survey certification by keeping it up to date and accurate, and call the insurance company and/or surveyor to update or recertify the survey as needed.

F. Appraisal

It is axiomatic that an appraisal must take place before a lender will issue funds for the purchase of real property. The purpose of the appraisal is to verify that the subject property has a market value commensurate with the loan amount. The appraisal also serves the function of allowing the lender to evaluate the subject property when deciding whether to issue a loan. Because the appraisal is an important component of the real estate deal, the appraisal should be performed by an appraiser with professional certification or other credentials establishing the appraiser's competence.[3] Finally, to avoid the appearance of any "taint" to the appraisal process, the appraisal should be initiated by the lender.

The first step of any appraisal is a site inspection to verify the condition of the property. Following inspection, the appraiser will prepare a written appraisal estimating the value of the property. Typically, the appraiser will use one (or more) of three standard methods for estimating the value of the property, depending on the type and location of the property. The three methods are (1) the Sales Comparison Approach; (2) the Cost Approach; and (3) the Income Approach.

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[3] The Appraisal Standards Board of the Appraisal Foundation promulgates the Uniform Standards of Professional Appraisal Practice, commonly known as "USPAP". This document, recognized by Congress as the generally accepted appraisal standard, covers appraisal valuations of real property, personal property, and business or intangible assets. The USPAP can be purchased at www.appraisalfoundation.org.

1. The Sales Comparison Approach

The sales comparison approach is the most common and reliable method for estimating the market value of residential real estate. This approach utilizes an analysis of the selling price of comparable properties within the geographic area closely surrounding the subject property. This provides a close approximation of the "going rate" for similar property in the area. A property is considered comparable if it closely resembles the subject property in terms of design and layout, square footage, lot size, quality of construction, age, physical condition, number of rooms, and other physical characteristics. In an attempt to control for differences in property characteristics, appraisers will include standardized adjustments to the selling prices for variations in these criteria. For example, a standard dollars per square foot calculation will be utilized to adjust for differences in the square footage of the subject property and the comparable property.

A sales comparison analysis generally involves three sets of data. First, the appraiser will research the range of asking prices for all comparable properties in the neighborhood. Second, the appraiser will research the selling price for all comparable properties recently sold in the neighborhood. Finally, the appraiser will perform a detailed comparative analysis of the subject property and several comparable properties, making adjustments for variations in property characteristics. Based on these data sets, the appraiser will determine the estimated market value of the subject property.

2. The Cost Approach

The cost approach utilizes a projection of the total cost to fabricate an exact replica of the subject property. Because the cost approach does not take into consideration "real world" factors such as rental income potential or comparable sales figures, it is typically considered a secondary

method of appraisal for both residential and commercial property. However, this approach is valuable as it can serve as a control for inconsistencies in the other methods.

The cost approach involves a calculation of the value of the land, plus the cost of reconstructing any improvements, less any depreciation to the improvements present on the subject property. Although this is a logical method of determining the value of a property, it is subject to several limitations. For instances, although the method is fairly reliable for newer properties, changes in building techniques and materials make it less reliable for older buildings. Additionally, unique and costly improvements to a property do not always translate into an equivalent increase in market value.

3. The Income Approach

The income approach, also called the income capitalization approach, is most appropriate in the context of transactions involving income generating commercial property. This method involves an estimate of the value of property in relation to the income that the property produces. Appraisers generally determine the monthly or yearly net income generated by the property, and multiply that figure by a standard income multiplier to determine the estimated value of the property. This method is especially preferable for commercial properties that have unique characteristics or other income generating features that render the property unsuitable for the sales comparison or cost approach.

G. UCC Article 9 Searches

1. Why is Article 9 Important in the Real Estate Lending Context?

Article 9 of the Uniform Commercial Code, ("UCC"), governs the creation and perfection of valid security interests in personal property in Minnesota. Article 9 is important in the real estate lending context because many real property loan transactions involve a lender

taking security interests in personal property (such as furnishings, fixtures and equipment) as well as a mortgage on the real property. The provisions of Article 9 must be followed both with respect to the creation and perfection of a security interest in personal property, and also the enforcement of any default in the underlying loan documents and foreclosure upon the personal property. Thus, some key concepts in the Article 9 context include: (a) attachment, (b) perfection, (c) priority, and (d) enforcement after default.

a. Attachment

A security interest attaches to collateral when it becomes enforceable against the debtor with respect to the collateral, unless an agreement expressly postpones the attachment. Minn. Stat. § 336.9-203(a). Subject to certain exceptions, a security interest is enforceable against the debtor and third parties with respect to the collateral only if: (1) value has been given; (2) the debtor has rights in the collateral or the power to transfer rights in the collateral to a secured party; and (3) **one** of the following conditions is met:

> a. the debtor has authenticated a security agreement that provides a description of the collateral and, if the security interest covers timber to be cut, a description of the land concerned;
>
> b. the collateral is not a certificated security and is in the possession of the secured party…pursuant to the debtor's security agreement;
>
> c. the collateral is a certificated security in registered form and the security certificate has been delivered to the secured party…pursuant to the debtor's security agreement; or
>
> d. the collateral is deposit accounts, electronic chattel paper, investment property, letter of credit rights, or electronic documents, and the secured party has control…pursuant to the security agreement.

Minn. Stat. § 336.9-203(b).

A security agreement is effective according to its terms between the parties, against purchasers of the collateral, and against creditors. Minn. Stat. § 336.9-201. Additionally, a

security agreement may create or provide for a security interest in after-acquired collateral and may provide that collateral secures future advances or other value, whether or not the advances are given pursuant to the commitment (**NOTE: remember that a security interest does not become enforceable until value is given**). Minn. Stat. § 336.9-204.

b. Perfection

A security interest is perfected if it has attached and all of the applicable requirements for perfection…have been satisfied. Minn. Stat. § 336.9-308. In the great majority of cases, perfection of a security interest is accomplished by either filing a financing statement **or** by the secured party having "control" over the collateral.

i. Perfection by Filing a Financing Statement

Communication of a record to a filing office and tender of the filing fee, or acceptance of the record by the filing office, constitutes filing. Minn. Stat. § 336.9-516. The appropriate filing office for an interest in fixtures or timber to be cut is the office where the mortgage on real property is recorded (i.e., in Minnesota, the county recorder). Minn. Stat. § 336.9-501. For all other interests, the financial statement should be filed with the central filing system operated by the office of the Secretary of State. Id.

In order to be sufficient, a financing statement must (1) provide the name of the debtor; (2) provide the name of the secured party; (3) indicate the collateral covered by the financing statement; and (4) real-property related financing statements must indicate that it covers the type of collateral (as-extracted collateral, timber cut or fixtures), that it is to be filed in the real estate records, contains a legal description of the real property and the name of the owner of the real property. Minn. Stat. § 336.9-502. If the debtor is a registered organization, the public name of the organization must be listed; a trade name only is insufficient. Minn. Stat. § 336.9-503. The

indication of Collateral is sufficient if it (A) contains a description of the collateral which reasonably identifies it; or (B) indicates that it covers all assets or all personal property of the debtor. Minn. Stat. § 336.9-504.

Minor errors and omissions are acceptable. However, a financing statement that fails to sufficiently identify the debtor is seriously misleading and is insufficient. Minn. Stat. § 336.9-506. A properly filed financing statement remains valid even if the collateral is sold or disposed of. Minn. Stat. § 336.9-507. Additionally, a financing statement may be amended by filing an amendment, or terminated by filing a termination statement. Minn. Stat. §§ 336.9-512 - 336.9-513.

ii. Perfection by Control

The other means of perfecting a security interest is by "control." If an equity interest is being pledged and is evidenced on a certificate, the secured party should hold the original certificate to have "control." A security interest in a letter of credit or deposit account may be perfected only by control. Minn. Stat. § 336.9-312. A security interest in investment property, electronic chattel paper, or electronic documents may be perfected by control. Minn. Stat. §§ 336.9-312, 336.9-314.

c. Priority

"Priority" refers to the order of secured creditors' rights in collateral when multiple security interests have been created with respect to the collateral. The general rule is that the first creditor to file is the first in priority. Minn. Stat. § 336.9-322. However, a **key exception** to this rule comes in the case of investment property. A security interest in investment property perfected by control **takes priority over** a security interest in investment property perfected by filing (Again, get control of the certificate). Minn. Stat. § 336.9-328.

With respect to future advances, the security interest arises when the first advance is made; future advances can be "tacked" to the date of the original advance. Minn. Stat. § 336.9-323. Finally, a possessory lien on goods has priority over a security interest in the goods unless the lien is created by a statute that expressly provides otherwise. Minn. Stat. § 336.9-333.

d. Enforcement after Default

After a default, a secured party may reduce its claim to judgment or foreclose upon the collateral. Minn. Stat. § 336.9-601 (**PRACTICE TIP**: Send a written notice of default prior to commencing an action to recover the collateral.) A secured party may notify the account debtor to make payment directly to secured party. Minn Stat. § 336.9-607. Furthermore, after a default the secured party can enter upon real property and remove the fixtures, but must reimburse the debtor for any injury caused by the removal. Minn. Stat. § 336.9-604. In any event, proceeds are applied in the following order: (1) the reasonable expenses of collection and enforcement; (2) the satisfaction of obligations secured by the security interest; and (3) the satisfaction of any subordinate obligations. Minn. Stat. § 336.9-608.

Additionally, a secured party may take possession of the collateral after default. Minn. Stat. § 336.9-609. The secured party may take possession and dispose of collateral at debtor's premises without removal, may proceed pursuant to judicial process (replevin action), and may require the debtor to assemble the collateral and make it available to the secured party at a place TBD by the secured party. Id. Once possession is acquired, the secured party may dispose of the collateral in a number of ways. The secured party may sell the collateral, and the secured party may purchase the collateral at sale. Minn. Stat. § 336.9-610. However, the secured party must notify the debtor and any secondary obligor of the disposition, as well as any others with claims against the collateral who request notice. Id. The secured party can retain the collateral

in full or partial satisfaction of the obligation **only if** no objections are received. Minn. Stat. § 336.9-620. (**PRACTICE TIP**: Move quickly to enforce your rights in secured collateral; in many cases a bankruptcy filing might be imminent and other creditors will want to tie up the collateral in order to satisfy obligations owed to them.)

2. The Mechanics of an Article 9 Search

Because UCC filings are maintained by the Minnesota Secretary of State, a UCC Article 9 search is performed through the UCC division of the Secretary of State's office. The search can be done either through a legal courier service, or by establishing a pre-paid account on the Secretary of State's website. In either case, the Secretary of State's office does not provide expedited orders for UCC documents, so the turn-around time is about one week.

a. Using a Legal Courier

There are several reliable legal courier companies that regularly perform UCC document requests from the Secretary of State. You will need to provide them with the name of the company or individual you want searched. They will then submit a request for the relevant documents, and the Secretary of State will send the results back by mail, typically in about a week. As mentioned above, the Secretary of State does not accept expedited orders for UCC searches, so the courier cannot get the results from the Secretary of State over the counter.

The cost of the search with copies of the accompanying filing documents is $20.00, in addition to any fees charged by the courier company. For a reduced fee, you can also run the search without any accompanying filing documents, in which case you will get a printout that indicates the name of the secured party, the date of filing, the anticipated date of termination of the filing, the filing number and any other filings that are associated with the original, such as amendments and/or terminations. However, this printout will only indicate the identity of a

secured party, not the collateral associated with the security interest. In order to acquire this information, it is necessary to order copies of the accompanying filing documents. Therefore, it may save time to order the search with the accompanying documents.

b. Using a Prepay Account

An Article 9 search can also be conducted by setting up a prepay account with the Secretary of State's website. One of the advantages of this method is avoiding the additional courier fees incurred by having the courier submit the request for you. Also, prepay accounts generally diminish the turn-around time associated with receiving documents. Details for setting up the account are available on the website.

Once you have established a prepay account, you can log on to the fee-based portion of the Secretary of State website and conduct a debtor name search for $5.00. There is an on-line form to input the debtor name, either company or individual, and an optional address. Starting with the debtor name search is a good first step as it is cheap and immediate. If there are no results (no filings have been recorded for that debtor name), then you have a strong indication that there are no outstanding security interests. On the other hand, if there are filings against the debtor, the results of the debtor name search will have some basic filing information, such as the debtor name, the filing date of the interest, any anticipated termination date, and the filing number.

Once you have acquired the UCC filing numbers via the debtor name search, you can retrieve some additional information for free by looking up the filings by number. This will give you a little more information, such as the secured party name, but not the collateral description. In order to get the full description, you will need to order copies of the filing documents from the Secretary of State for $20.00, which can be done using the prepay account. It will take about a

week to get the search results with copies back from the Secretary of State. Again, in order to save time and conduct an adequately thorough search, it may be a good idea to order the complete search with filing documents at the outset.

c. Practical Advice for Conducting an Article 9 Search

The results of a search can vary depending on the search terms that are provided to the courier or input on-line. Leaving off addresses and using the simplest form of the company name or individual name will broaden the scope of the search, correcting for variations in the filing documents and ensuring complete results. The following examples help to illustrate this point:

- Omit corporate entity designations:
  - Rather than searching for "Acme Widget Company, LLC" search for "Acme Widget Company," leaving off the entity designation.
  - Errors can be made regarding company names – adding an entity designation will limit the search results to companies with that designation.
  - Thus, if "Acme Widget Company, LLC" changes to "Acme Widget Company, Inc." the search results will be incomplete.
- Omit middle initials and other personal designations:
  - Rather than searching for John C. Smith, Jr., search for John Smith and leave out the middle initial and the "Jr."
  - A search for John C. Smith, Jr., won't get any results for John C. Smith, or John Smith
- Leave the address field blank:
  - Rather than providing the current address, do not provide any address information.
  - Debtors can change addresses over time. Entering the current address can limit the search results and exclude results for any other addresses the debtor used in the past.

Broadening the search results will correct for variations associated with UCC filings, generating the most complete results. Although the search will likely be over-inclusive, a determination can be made, based on the documents, as to whether a given UCC filing pertains to the relevant debtor.

Section II Appendix

Exhibit A – Phase I Environmental Site Assessment Process

E1527-05 Standard Practice for Environmental Site Assessments:
Phase I Environmental Site Assessment Process

1. Scope

1.1 *Purpose*---The purpose of this practice is to define good commercial and customary practice in the United States of America for conducting an environmental site assessment of a parcel of commercial real estate with respect to the range of contaminants within the scope of Comprehensive Environmental Response, Compensation and Liability Act (CERCLA) (42 U.S.C. 9601) and petroleum products. As such, this practice is intended to permit a user to satisfy one of the requirements to qualify for the innocent landowner, contiguous property owner, or bona fide prospective purchaser limitations on CERCLA liability (hereinafter, the "landowner liability protections," or "LLPs"): that is, the practice that constitutes "all appropriate inquiry into the previous ownership and uses of the property consistent with good commercial or customary practice" as defined at 42 U.S.C. 9601(35)(B). (See for an outline of CERCLA's liability and defense provisions.) Controlled substances are not included within the scope of this standard. Persons conducting an environmental site assessment as part of an EPA Brownfields Assessment and Characterization Grant awarded under CERCLA 42 U.S.C. 9604(k)(2)(B) must include controlled substances as defined in the Controlled Substances Act (21 U.S.C. 802) within the scope of the assessment investigations to the extent directed in the terms and conditions of the specific grant or cooperative agreement. Additionally, an evaluation of business environmental risk associated with a parcel of commercial real estate may necessitate investigation beyond that identified in this practice (see Sections 1.3 and 13).

1.1.1 *Recognized Environmental Conditions*---In defining a standard of good commercial and customary practice for conducting an environmental site assessment of a parcel of property, the goal of the processes established by this practice is to identify recognized environmental conditions. The term recognized environmental conditions means the presence or likely presence of any hazardous substances or petroleum products on a property under conditions that indicate an existing release, a past release, or a material threat of a release of any hazardous substances or petroleum products into structures on the property or into the ground, ground water, or surface water of the property. The term includes hazardous substances or petroleum products even under conditions in compliance with laws. The term is not intended to include de minimis conditions that generally do not present a threat to human health or the environment and that generally would not be the subject of an enforcement action if brought to the attention of appropriate governmental agencies. Conditions determined to be de minimis are not recognized environmental conditions.

1.1.2 *Petroleum Products*---Petroleum products are included within the scope of this practice because they are of concern with respect to many parcels of commercial real estate and current

custom and usage is to include an inquiry into the presence of petroleum products when doing an environmental site assessment of commercial real estate. Inclusion of petroleum products within the scope of this practice is not based upon the applicability, if any, of CERCLA to petroleum products. (See X1.7 for discussion of petroleum exclusion to CERCLA liability.)

1.1.3 *CERCLA Requirements Other Than Appropriate Inquiry*---This practice does not address whether requirements in addition to all appropriate inquiry have been met in order to qualify for the LLPs (for example, the duties specified in 42 U.S.C. 9607(b)(3)(a) and (b) and cited in Appendix X1, including the continuing obligation not to impede the integrity and effectiveness of activity and use limitations (AULs), or the duty to take reasonable steps to prevent releases, or the duty to comply with legally required release reporting obligations).

1.1.4 *Other Federal, State, and Local Environmental Laws*---This practice does not address requirements of any state or local laws or of any federal laws other than the all appropriate inquiry provisions of the LLPs. Users are cautioned that federal, state, and local laws may impose environmental assessment obligations that are beyond the scope of this practice. Users should also be aware that there are likely to be other legal obligations with regard to hazardous substances or petroleum products discovered on the property that are not addressed in this practice and that may pose risks of civil and/or criminal sanctions for non-compliance.

1.1.5 *Documentation*---The scope of this practice includes research and reporting requirements that support the user's ability to qualify for the LLPs. As such, sufficient documentation of all sources, records, and resources utilized in conducting the inquiry required by this practice must be provided in the written report (refer to 8.1.8 and 12.2).

1.2 *Objectives*---Objectives guiding the development of this practice are (1) to synthesize and put in writing good commercial and customary practice for environmental site assessments for commercial real estate, (2) to facilitate high quality, standardized environmental site assessments, (3) to ensure that the standard of all appropriate inquiry is practical and reasonable, and (4) to clarify an industry standard for all appropriate inquiry in an effort to guide legal interpretation of the LLPs.

1.3 *Considerations Beyond Scope*---The use of this practice is strictly limited to the scope set forth in this section. Section of this practice identifies, for informational purposes, certain environmental conditions (not an all-inclusive list) that may exist on a property that are beyond the scope of this practice but may warrant consideration by parties to a commercial real estate transaction. The need to include an investigation of any such conditions in the environmental professional's scope of services should be evaluated based upon, among other factors, the nature of the property and the reasons for performing the assessment (for example, a more comprehensive evaluation of business environmental risk) and should be agreed upon between the user and environmental professional as additional services beyond the scope of this practice prior to initiation of the environmental site assessment process.

1.4 *Organization of This Practice*---This practice has thirteen sections and four appendixes. Section 1 is the Scope. Section 3 is Referenced Documents. Section , Termninology, has definitions of terms not unique to this practice, descriptions of terms unique to this practice, and acronyms. Section is Significance and Use of this practice. Section provides discussion regarding activity and use limitations. Section describes User's Responsibilities. Sections are the main body

of the Phase I Environmental Site Assessment, including evaluation and report preparation. Section provides additional information regarding non-scope considerations (see). The appendixes are included for information and are not part of the procedures prescribed in this practice. explains the liability and defense provisions of CERCLA that will assist the user in understanding the user's responsibilities under CERCLA; it also contains other important information regarding CERCLA, the Brownfields Amendments, and this practice. provides the definition of the environmental professional responsible for the Phase I Environmental Site Assessment, as required in the "All Appropriate Inquiry" Final Rule (40 C.F.R. Part 312). provides an optional User Questionnaire to assist the user and the environmental professional in gathering information from the user that may be material to identifying recognized environmental conditions. provides a recommended table of contents and report format for a Phase I Environmental Site Assessment.

This standard does not purport to address all of the safety concerns, if any, associated with its use. It is the responsibility of the user of this standard to establish appropriate safety and health practices and determine the applicability of regulatory limitations prior to use.

1.5 This practice offers a set of instructions for performing one or more specific operations. This document cannot replace education or experience and should be used in conjunction with professional judgment. Not all aspects of this practice may be applicable in all circumstances. This ASTM standard is not intended to represent or replace the standard of care by which the adequacy of a given professional service must be judged, nor should this document be applied without consideration of a project's many unique aspects. The word "Standard" in the title means only that the document has been approved through the ASTM consensus process.

Exhibit B – Phase II Environmental Site Assessment Process

E1903-97(2002) Standard Guide for Environmental Site Assessments:
Phase II Environmental Site Assessment Process

1. Scope

1.1 This guide covers a framework for employing good commercial and customary practices in conducting a Phase II environmental site assessment (ESA) of a parcel of commercial property with respect to the potential presence of a range of contaminants which are within the scope of CERCLA as well as petroleum products.

1.1.1 This guide is intended to provide practical procedural guidance for the continuation of an assessment conducted in accordance with the most recent edition of Practice E 1527 or E 1528, or both. Practice E 1527 is the practice for conducting Phase I ESAs for a parcel of commercial property and Practice E 1528 is the transaction screen practice. Both practices define a process that is intended to constitute "all appropriate inquiry into the previous ownership and uses of a property" to determine whether hazardous substances or petroleum products have been disposed or released there in order to satisfy one element of the innocent purchaser defense to CERCLA liability.

1.1.2 Because this guide for conducting Phase II ESAs describes a process for further evaluating a parcel of commercial property with recognized environmental conditions, as defined in Practices E 1527 and E 1528, users of this guide should understand the requirements and limitations of those practices. It is strongly recommended that the user refer to and apply the guide in concert with Practices E 1527 and E 1528.

1.1.3 This guide has multiple purposes. It is intended to provide assistance to users in satisfying the appropriate inquiry element of CERCLA's innocent purchaser defense, as defined in 42 U.S.C. § 9601(35)(B), where a previous assessment satisfying that element identified recognized environmental conditions. This guide also is intended to assist a user in gathering reliable information about a property's environmental conditions to guide the user's business decisions. However, this guide does not purport to include the level of specificity required of technical standards that govern full characterization of a site's environmental conditions.

1.2 *Objectives*—The primary objectives of conducting a Phase II ESA are to evaluate the recognized environmental conditions identified in the Phase I ESA or transaction screen process for the purpose of providing sufficient information regarding the nature and extent of contamination to assist in making informed business decisions about the property; and where applicable, providing the level of knowledge necessary to satisfy the innocent purchaser defense under CERCLA.

1.2.1 To achieve these objectives, it may be appropriate to perform more than a single iteration of assessment. The guide fosters an iterative approach to Phase II assessments and allows the user to terminate the Phase II ESA at the point where sufficient data have been generated to meet the user's objectives.

1.2.2 At the completion of a Phase II ESA, the environmental professional should be able to conclude, at a minimum, that either *(a)* the ESA has provided sufficient information to render a professional opinion that there is no reasonable basis to suspect the presence of hazardous substances or petroleum products at the property associated with the recognized environmental conditions under assessment, or *(b)* the ESA has confirmed the presence of hazardous substances or petroleum products at the property under conditions that indicate disposal or release. If the information developed in the ESA is insufficient for the environmental professional to reach either of these conclusions, the environmental professional may recommend additional iterations of assessment if warranted to meet the objectives of the user. If the environmental professional reasonably suspects that unconfirmed hazardous substance or petroleum releases remain but concludes that further reasonable assessment is not expected to provide additional information of significant value, he may recommend that further assessment is not warranted. In such circumstances, the recommendation for no further assessment should be accompanied by an explanation why a reasonable suspicion of releases remains and why further reasonable assessment is not warranted. Depending upon the work scope, the environmental professional may also be able to provide guidance on the nature and extent of contamination in order to assist the user in making business decisions regarding the property.

1.2.3 This guide is intended to provide guidance for assessing recognized environmental conditions and developing technically sound data. It is not intended to satisfy the level of inquiry that may be necessary to support remedial solutions for a site. For further discussion of the use of this guide, refer to Section on Significance and Use.

1.3 *Needs of the User*—Establishing the innocent purchaser defense may not be a realistic objective in some instances. Accordingly, the extent of assessment is based on the business objectives of the user as well as the degree of uncertainty acceptable to the user. In either case, the primary purpose of a Phase II ESA conducted in accordance with this guide is to assess and evaluate the recognized environmental conditions identified in the Phase I ESA or Transaction Screen Process.

1.3.1 The mere confirmation of contamination or the preliminary indication of the extent and magnitude of contamination may be sufficient for the purposes of many users. If a user desires a more complete characterization of the environmental condition of the property, further assessment may be undertaken. However, this guide should not be construed to require multiple iterations of assessments in all cases, either to establish the innocent purchaser defense or to meet other objectives. Many Phase II ESAs may in fact be restricted to only a single round of assessment, whatever the extent of contamination, if any, that might be revealed.

1.4 *Limitations*—The use of this guide is related to the scope as set forth in Section 1. For information purposes, Section 12 of this guide contains a non-exhaustive list of certain environmental conditions that are beyond the scope of this guide but that may warrant consideration by parties to a commercial property transaction. This guide provides an approach that may be employed to assess the environmental conditions listed in Section 12. Reference also should be made to 4.1.

1.5 *Organization of This Guide*—This guide has twelve sections and one appendix. Section 1 is the Scope section. Section 2 is Referenced Documents. Section 3, Termninology, contains definitions of terms and acronyms used in this guide. Section 4 is Significance and Use of this

guide. Section 5 is Contracting Considerations. Sections 6-11 constitute the main body of the Phase II Environmental Site Assessment guide and include objectives (see Section 6), developing the scope of work (see Section 7), assessment activities (see Section 8), evaluation of data (see Section 9), interpretation of results (see Section 10) and recommended report preparation (see Section 11). Section 12 provides additional information regarding non-scope considerations. provides a sample table of contents and report format for a written Phase II Environmental Site Assessment Report.

III. Construction Lending/Financing

A. LAND ACQUISITION AND DEVELOPMENT LOANS

1. Introduction

Construction is costly. The owner of a construction project is likely to finance at least a portion of the costs of the construction project. Only a small portion of individuals or businesses that build structures have sufficient funds available to pay for the construction costs, and even if such funds are available, an individual or business may not be willing to use them for construction costs. This financing affords the owner a great deal of leverage in the investment meaning that there will be a higher percentage of return on the owner's invested capital. Income tax laws also provide significant benefit to financing construction projects because the amount of indebtedness of the owner can be included in the tax basis of the property.[4]

Ironically, however, almost all of the expense involved in designing, planning, and building a structure of any kind must be incurred and paid before the structure begins to generate income. Therefore, the main issue facing owners of construction projects, who are seeking a land acquisition and development loan, is determining how to collateralize and secure the loan while improvements are being made to the land. The construction financing system is equipped to handle this issue, but it is not a standardized system such as the home mortgage system. As a result, there are many variables to consider when seeking construction financing.

2. Pre-Construction Costs

A land acquisition and development loan is commonly referred to as a construction loan. However, it is essential to consider the stage of development at which a loan is made. An

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[4] See generally Strum, Today's Real Estate Financing Climate, Some of the Causes and Some of the Problems, 13 Real Prop. Prob. and Tr. J. 757 (1978).

important consideration at any stage of construction financing is the amount of the project cost that the lender is willing to lend.

The owner may have incurred substantial project debt before becoming ready to begin construction.[5] These costs can include acquisition of the land (often done through an acquisition loan) and development of the land through the services of architects, engineers, and land planners (often called a development loan). In addition, owners may have to pay for infrastructure installation or refurbishment and other costs such as attorney's fees relating to zoning or other pre-construction legal matters. These pre-construction costs may affect an owner's ability to obtain future financing.

3. The Construction Loan

Any pre-construction acquisition and development costs are likely to be "rolled over" into a construction loan. Therefore, pre-construction costs are often repaid upon receipt of a construction loan. A construction loan provides sufficient funds to pay all of the costs of completing the construction project and fully developing land. A construction loan can be for the entire amount of the project or it can be for a certain percentage of the project that is offset by whatever capital and/or equity the owner decides to commit or the lender requires the owner to commit. If an owner already owns the land, then it can be considered as equity on the construction loan.

a. Form of Loan

The construction loan is intended to provide financing for the construction project, so a construction loan, unlike a mortgage, is not usually meant to be around for a long time.

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[5] For a general discussion of the types of expenses which often precede the funding of a construction loan, see Livingston, *Current Business Approaches – Commercial Construction Lending*, 13 Real Prop. Prob. & Tr. J., 791, n.4 at 797 (1974).

Construction loans typically require interest-only payments during construction and become due in full upon completion. If the loan cannot be repaid in full upon completion of the project, many owners use construction-to-permanent financing programs. In that manner, the construction loan is converted to a mortgage loan after the certificate of occupancy is issued on the property.

b. Disbursement

It is important to consider the manner in which the proceeds from a construction loan are disbursed. There is a tension between the underlying needs of a lender to ensure that funds will not be diverted by a builder or owner for other purposes and the underlying needs of an owner to ensure that builders or other parties receive payments so that construction will go forward. Therefore, construction lenders have developed disbursement systems to ease this tension.

i. Draw system

The builder and the lender establish a draw schedule based on stages of construction. Typically, the lender will inspect construction and advance money only if the project is proceeding according to plan. However, the payments are made directly to the owner or the builder, so it may be difficult to prevent diversion under this method.[6]

ii. Voucher System

Under a voucher system, the lender pays a builder or supplier directly upon issuance of an order, the voucher, by the general contractor or owner of the project.[7] This reduces the chances of fraud or misrepresentation,[8] but it may subject the lender to claims of negligent disbursement[9] or operate to confer third-party beneficiary status on the payee.

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[6] *See Henslee v. Houston*, 566 F.2d 475 (5th Cir. 1978).
[7] *See, e.g., Int'l Paper co. v. Futhey*, 788 S.W.2d 303 (Mo. Ct. App. 1990).
[8] *But see Bwinnell v. Oftedahl*, 235 Minn. 383, 51 N.W.2d 93 (1952).
[9] *See Rucker v. Wyandotte Sav. Bank*, 148 N.W.2d 532 (1967)

iii. Other Disbursement Methods

Lenders may transfer funds to an escrow agent thereby delegating the responsibility and liability for disbursement of the funds.[10] Lender bonding may also be an alternative.[11]

c. Interest

Most construction lenders want to know the story behind the planned construction before they are willing to make a construction loan. There can also be a great deal of risk in construction lending. Therefore, interest rates can be charged at the lender's prime rate, or even a point or two higher (provided they are not usurious).

Construction loans are usually variable-rate loans priced at a spread to the prime rate or some other short-term interest rate. Interest is then charged on the amount of money disbursed to date. Owners could purchase some type of rate-lock agreement valid through the expected completion of the construction. However, there should be allowances made for inevitable construction delays. Owners may be willing to pay a higher rate on the construction loan if they are doing construction-to-permanent financing and can get better mortgage terms or a longer, better rate lock from the lender.

4. Construction-to-Permanent Financing

Construction financing can be a risky endeavor. A construction loan is short-term in nature, and as a result, interest rates are usually higher than they are with longer, more permanent loans. In addition, a construction loan typically matures upon completion of construction on the project. Construction loans and other, more permanent financing structures usually include some

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[10] *Costanzo v. Stewart Title & Trust*, 533 P.2d 73 (1975).
[11] See Rodimer, *Use of Bonds in Private Construction,* 7 Forum 235 , 242-44 (1972).

form of anticipated date of completion. Many things can go awry from the time construction is commenced until the time that a project is completed and placed in service in an income-earning capacity. For example, there could be worker strikes, material shortages, or disputes with contractors. Delays in completion result in increased interest costs, delayed income, and possibly even maturity of some financing arrangements. Therefore, it is often necessary for an owner to finance construction projects through the use of construction loans in conjunction with one of the more permanent loan commitments that are discussed in the rest of this section. A more permanent loan structure will allow the refinance of a construction loan upon completion of the project.

A sample construction loan agreement may be found in the appendix as Exhibit A.

B. LETTERS OF CREDIT / SECURED AND UNSECURED LINES OF CREDIT

1. Introduction

A letter of credit is "an instrument under which the issuer (usually a bank), at a customer's request, agrees to honor a draft or other demand for payment made by a third party (the beneficiary), as long as the draft or demand complies with specified conditions, and regardless of whether any underlying agreement between the customer and the beneficiary is satisfied."[12] A letter of credit may be issued by any person or entity; however typically letters of credit are issued by banks.

Letters of credit are governed by Article 5 of the Uniform Commercial Code ("UCC"); in Minnesota Article 5 of the UCC is codified at Minnesota Statutes Section 336.5-101 et al. Generally a letter of credit constitutes a written promise by the issuer to pay money to the beneficiary when the issuer receives documents required by the letter of credit. Aside from an

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[12] BLACK'S LAW DICTIONARY 414 (2d Pocket Ed. 2001).

issuer and beneficiary, letters of credit also require an applicant; the borrower that submits the letter of credit to the lender for payment is considered the applicant.

Letters of credit may be secured or unsecured; a secured letter of credit is back by collateral of some sort in addition to the security of penalty by law and creditworthiness of the issuer backing an unsecured letter of credit. Regardless of whether a letter of credit is secured, all letters of credit must meet certain statutory format requirements.

2. Letters of Credit Format

Pursuant to Minnesota law a letter of credit "may be issued in any form that is a record and is authenticated (1) by a signature or (2) in accordance with the agreement of the parties or standard practice."[13] No consideration is required for the issuance of a letter of credit.[14] According to Minnesota law a letter of credit is deemed issued and enforceable when the issuer, typically a bank, sends the letter to the beneficiary.[15]

Generally, a letter of credit should contain the following information:

1. the maximum amount that may be drawn from the letter;
2. whether multiple drafts of the letter of credit may be presented to the issuer;
3. the requirements that a beneficiary must meet to draw on the letter of credit; and
4. the date of expiration of the letter of credit.

A sample letter of credit may be found in the Appendix as Exhibit B. This sample is an "Irrevocable Standby Letter of Credit," and it sets forth the requirements for drafts of the letter of

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[13] Minn. Stat. § 336.5-104 (1997).
[14] Minn. Stat. § 336.5-105.

credit, the expiration of the letter of credit and the manner in which money may be drawn from the letter.

A letter of credit may only be revoked if the terms of the letter allow revocation.[16] An issued letter of credit may be amended or cancelled; however the rights and obligations of the beneficiary of the letter of credit remain unchanged unless they consent to the amendment or cancellation.[17] The duration of a letter of credit depends upon the wording of the letter. If a letter contains no expiration date the letter will expire one year after it is issued; if a letter states that it has perpetual duration the letter will expire five years after it is issued.[18]

3. Issuer's Rights and Obligations Under Letters of Credit

Pursuant to Minnesota law, the issuer of a letter of credit "shall observe standard practices of financial institutions that regularly issue letters of credit."[19] What constitutes observance of standard practices is a question of law.[20] Upon receipt of a letter of credit an issuer has no more than seven business days to honor the letter of credit or report discrepancies to the presenter of the letter of credit.[21]

An issuer of a letter of credit is not responsible under Minnesota law for either[22]:

1. the contract or agreement underlying the letter of credit;
2. acts or omissions of others; or
3. observance or knowledge of standard practices outside of its trade.

Upon honoring a letter of credit an issuer is entitled to[23]:

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[15] Minn. Stat. § 336.5-106, subd. a.
[16] *Id.*
[17] Minn. Stat. § 336.5-106, subd. b.
[18] Minn. Stat. § 336.5-106, subd. c-d.
[19] Minn. Stat. § 336.5-108, subd. c.
[20] *Id.*
[21] Minn. Stat. § 336.5-108, subd. b.
[22] Minn. Stat. § 336.5-108, subd. f.
[23] Minn. Stat. § 336.5-108, subd. j.

1. reimbursement by the applicant no later than the date of its payment of the letter of credit;

2. take the letter of credit free of claims; and

3. discharge to the extent of its performance.

After honoring a letter of credit an issuer is precluded from asserting a right of recourse and from restitution of money paid by mistake due to obvious discrepancies in the letter of credit.[24]

4. Beneficiary Rights and Obligations Under Letters of Credit

If a letter of credit is honored by its issuer Minnesota law dictates that the beneficiary of the letter of credit warrants that: (1) there is no fraud or forgery with respect to the letter of credit; and that (2) that his/her drawing off of the letter of credit does not violate any agreements made by him/her.[25]

Pursuant to Minnesota law, if an issuer wrongfully dishonors or repudiates its obligation to pay under the letter of credit, the beneficiary or a nominated person may recover from the issuer the amount due under the letter of credit, or may attain specific performance and incidental damages.[26]

5. Benefits of a Letter of Credit

A letter of credit greatly benefits a lender as the letter enhances a lenders security. A lender's security is enhanced as the value of a letter of credit is "set and cannot decrease, and it can be fully realized upon very quickly and inexpensively; thus letters of credit are often more advantageous in providing security than a mortgage.[27] A letter of credit is also advantageous to a lender as the only risk involved with a letter of credit is the issuer's insolvency; considering the

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[24] *Id.*
[25] Minn. Stat. § 336.5-110.
[26] Minn. Stat. § 336.111.
[27] Steven G.M. Stein, Construction Law § 14.02[6] (Vol. 4 2005).

fact that most issuers of letters of credit are banks, insolvency is unlikely and lenders are thus very secure under letters of credit.[28]

C. INTERIM AND LONG TERM FINANCING ARRANGEMENTS FOR COMPLETED STRUCTURES

Construction lenders and developers may desire additional assurance of long term financing for completed projects; this additional assurance is available in the form of a long term of permanent loan. The utilization of a long term loan provides assurance to lenders and developers that long term financing will be available to refinance, and repay, the interim construction loan.[29]

1. Format of the Permanent Loan Commitment

A lender has four areas of concern that should be satisfied before granting a permanent or long term loan: (1) concerns regarding the project itself; (2) concerns regarding the developer and other participants in the project; (3) concerns regarding the financial terms of the loan; and (4) concerns regarding the conditions precedent for funding of the loan.[30]

Before a permanent or long term loan is granted a lender must approve the design and construction of the project. Approval of the project will depend on the quality of the information provided to the lender by the borrower in the permanent loan commitment. A well drafted permanent loan commitment should contain a detailed description of the project with architectural plans and specifications. If the lender is satisfied with the project it will grant its approval of the plans and specifications; thus when a permanent loan is granted it should be

[28] *See Id.*
[29] *See* Steven G.M. Stein, Construction Law § 14.02[1] (Vol. 4 2005).
[30] *Id.*

documented by a permanent loan commitment containing a detailed description of the project as well as a representation of the lender's approval of the description.[31]

A lender must also approve of the developer and other participants of the project prior to granting a permanent loan.[32] Generally, a lender will approve of a developer when it is satisfied that the developer can complete the project according to the approved specifications and in a timely manner. The permanent loan commitment should specifically identify the developer of the project as well as any other individuals that the lender relied on in granting approval of the loan. For example, if a lender granted the permanent loan based on the fact that the developer used a specific contractor, the contractor should be named in the permanent loan commitment. As a related matter, if a contractor supplies a lender with the names of individuals that will be involved with the project in support of his/her loan application, the lender may request additional information regarding the reputation and financial strength of the other individuals. Additionally, prior to approving the permanent loan the lender may require that these individuals provide assurances that they will devote time and attention to the project.[33]

In general, a well-drafted permanent loan commitment should include the following[34]:

1. a detailed description of the project;
2. specific identification of the developer; as well as
3. specific identification of the owner(s), property manager, leasing agent, guarantors and anyone else whose involvement with the project played a role in the lender granting the loan.

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[31] *Id.*
[32] *Id.*
[33] *Id.*
[34] *Id.*

2. The Structure of a Permanent Loan

Prior to granting a permanent loan a lender must be satisfied with the financial terms of the loan. Specifically, the lender should strive for the most favorable loan disbursement schedule, interest rates, fee rates, and the loan term and application fee.

a. Loan Disbursements

In the construction loan context borrowers typically request loans for greater than the expense of the construction. In setting the maximum amount for a construction loan lenders will often choose a percentage of the appraised value of the construction project. The lender should also expressly provide or deny additional funding; in addition the permanent loan commitment must include a final deadline for disbursements.[35]

b. Interest

There are numerous methodologies for formulating the interest rates of a permanent loan; the formula chosen will depend on the negotiations of the lender and borrower and will generally result in a decision based on tax consequences.[36]

c. Loan Term

The permanent loan commitment must expressly provide for the maturity date of the loan; the maturity date may be expressed in the form of an actual calendar date or the occurrence of a specified installment payment.[37]

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[35] In addition, a force majeure extension may be included in the permanent loan commitment; but even where such an extension is available a final deadline for the extension must be expressly provided. *Id.*

[36] Common formulations include: fixed rate; pre-set rate scheduling; partial accrual rate with deferred payment obligations; floating rate; renegotiable rates; contingent interest; shared appreciation mortgage formula; joint venture; convertible mortgage; land sale-leaseback transactions; and pre-sale or turnkey contracts. For details on each formulation refer to *Id.*

[37] *Id.*

d. Loan Fees

Expected loan fees include application fees, lender investigation expenses, commitment fees, loan broker fees, appraisal expenses and lender's expenses.

e. Repayment of Permanent Loans

Repayment of the principal of permanent loans takes one of four forms: full amortization; partial amortization; non-amortizing; and negatively amortizing.[38] A permanent loan is fully amortized when each installment payment constitutes a payment of both the interest and a portion of the principal. The installments of a partially amortized loan constitute a lesser portion of the principal in addition to the interest accrued, necessitating a balloon payment. A non-amortizing loan requires installment payments for only the interest due, also necessitating a balloon payment. Under a negatively amortizing loan installment payments cover only part of the interest accrued, so at maturity of the loan the entire principal and accumulation of unpaid interest is due.

f. Due on Sale Clauses

Due on sale clauses give lenders the right to accelerate a permanent loan upon any transfer in ownership of a construction project. Because of the great power lying in the right to accelerate, due on sale clauses are often the subject of litigation; a lender is well advised to carefully draft its due on sale clause in order to prevent a court from interpreting the clause against its interests.

3. Conditions Precedent to Approval of Permanent Loan

The following conditions must be met before a lender is likely to approve a permanent loan: collateral; financial statements; insurance; evidence of good title; survey of property;

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[38] *Id.*

evidence of completion; assurances of leases; attorney opinions; inventory of property at the project; borrowers organizational documents; appraisal; representations and warranties; borrower's covenants; designation of loan as recourse or non-recourse; tax and insurance impounds; standby commitments; assignability; and environmental matters. Additionally, each of these conditions should be expressly provided for in the permanent loan commitment per the lender's requirements for each condition.

4. Permanent Loan Documentation

A permanent loan commitment should expressly dictate that the lender receive all documents deemed appropriate by the lender from the borrower in a reasonable time prior to the first disbursement of the loan. Typically, a lender will require the following documents: a promissory note; a mortgage or deed of trust; assignment of leases and rents; security agreement; financing statements; guaranties; and letters of credit. [39]

a. Promissory Note

A promissory note evidences the borrower's obligation under the permanent loan. Generally a promissory note contains the following information[40]:

1. the maximum amount of the loan;
2. the maturity date of the loan;
3. the interest rate of the loan;
4. a usury savings provision;
5. any prepayment provisions;
6. events triggering default;
7. lender's right to accelerate loan upon default;

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[39] *Id.*
[40] *Id.*

8. borrower waivers
9. whether the loan is recourse or non-recourse;
10. miscellaneous provisions such as notice and fee information.

b. Mortgage or Deed of Trust

A mortgage or deed of trust should contain provisions addressing the following:

1. timely payment of the principal, interest and fees associated with the permanent loan; and
2. timely performance of any obligations of the mortgagor per the loan agreement.

In addition, the mortgage or deed of trust should describe the property that it encumbers. Generally mortgages and deeds of trusts describe the following types of property: land, improvements, tangible personal property, fixtures, intangibles, rents, leases or building plans and specifications.[41] The mortgage or deed of trust should also address any borrower covenants and assignments of leases and rents.

c. Assignment of Leases

An assignment of leases and rents provides a lender with security for borrower's indebtedness in that the borrower avails himself to the lender of all right, title and interest in existing and future leases and rents derived from the construction project

d. Security Agreement and Financing Statements

A security agreement provides additional security to the lender for the borrower's indebtedness; a security agreement may be included within a provision of the mortgage or as a

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[41] *Id.*

supplemental loan document. Lenders granting permanent loans should also obtain Uniform Commercial Code financing statements from borrowers.[42]

e. Guaranties

Guaranties provide lenders with even more security on borrower's indebtedness as a guarantor guarantees that the lender will be paid for borrower's loan. Typical guaranties include provisions relating to the payment (not collection) of the debt, waivers, bankruptcy, death, subordination, exculpation and modifications of loan documents.[43]

f. Letters of Credit

A letter of credit from a creditworthy issuer provides a lender with the utmost security on its permanent loan. Letters of credit are generally issued by banks, and permit a lender to draw on the issuer for payment in the case of default; due to the fact the banks are generally solvent, a lender is almost guaranteed payment on a loan secured by a letter of credit.

5. Special Considerations

A lender granting a permanent loan must be aware of any senior mortgages to which the borrower is a party. If senior mortgages exist the lender must be aware of his status as a junior mortgagee and the priority consequences of that status should the borrower default. It is possible for a senior lien holder to subordinate itself to a lender granting a permanent loan under certain circumstances.[44]

Similarly, a lender granting a permanent loan to a borrower under a leasehold mortgage loan should take precautions to insure itself from negative consequences should the borrower default.[45]

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[42] UCC Section 9 provides regulations for the execution and filing of Financing Statements.
[43] For further details refer to *Id.*
[44] *Id.*
[45] *Id.*

6. Enforcement of the Permanent Loan Commitment

A permanent loan commitment is a contract between the lender and the borrower and may be enforced under the rules of contract law.

When a permanent loan commitment is enforced by a borrower against a lender, the problem typically stems from the lender's refusal to fund the loan because the borrower has not met certain conditions precedent. In these situations the lender may raise the following defenses: absence of consideration (likely not successful if the borrower has paid a commitment fee); a lack of definiteness in the commitment language; issuer's lack of authority; and/or some sort of violation of the law occurred in the making of the commitment. A borrower who suffers form a lender's wrongful breach of its permanent loan commitment may seek the following remedies: money damages stemming from the borrower's costs incurred in establishing replacement financing and potential increased cost in construction due to the delay caused by the borrower's breach; as well as the recovery of fees and deposits paid to the lender.

When a permanent loan commitment is enforces by a lender against a borrower, the triggering event typically surrounds a dispute regarding the lender's retention of fees and deposits. Many permanent loan commitments provide for non-refundable fees and refundable deposits; litigation typically ensues when refundable deposits are retained by the lender. A borrower may attempt to recover its deposit on a theory of usury; if successful the borrower may attain general damages.

D. MEZZANINE FINANCING

1. What is it?

Mezzanine financing is a method of financing designed to fill the gap between the first mortgage and the equity participation of the principals of the borrower. First mortgages usually

have a loan-to-value ratio of forty to seventy-five percent, while equity participation, in the normal case, consists of no more than ten percent of the cost of the project. Mezzanine financing commonly fills this "gap" by financing the remaining ten percent to fifty percent of the project's capital structure cost.

This method of financing is called "mezzanine" because of its tiered structure. The key to mezzanine financing is the creation of structural subordination in the entities that comprise the group of borrowers. A simple example will best illustrate the process: assume that a limited partnership owns a piece of property that needs capital improvements to be profitable. The property is already subject to a first mortgage, and the partnership is finding it difficult, for whatever reason, to find a lender willing to lend more money with the property as collateral. To solve this problem, the partnership could grant a mezzanine lender a limited partnership interest in the venture. The collateral for the mezzanine loan would be the pledge of the limited partnership interest to the mezzanine lender. The mezzanine lender thus has a claim against the equity interest in the mortgage borrower, but has no direct claim against the mortgaged property or the mortgage borrower, and, of course, no right to interfere with foreclosure by the holder of the first mortgage on the property. The mezzanine investor's interest in the partnership will be "preferred," in the sense that it will receive distributions of excess cash flow before the other limited partners.

2. Who uses it?

Entities which use mezzanine structures to finance their projects typically do so because they are in need of funds beyond what they are unable to secure through a first mortgage. Until recently, the most common way to do this was to simply secure a second mortgage, with the property as collateral. The second mortgagee would have a secured interest subordinate to the

senior mortgagee, making it less likely that it would be able to recover in case of default. Further, any borrower who would seek to place a higher level of debt on its property will generally be more likely to default in the end. As a result, second mortgagees would charge a higher interest rate to borrowers than senior mortgagees.

Since the mid-1990s, however, the use of second mortgages on property, especially in the commercial real estate context, has been on the decline. Many senior mortgagees now understand the increased difficulties of foreclosing on properties that are also subject to a second mortgage. Especially where the value of the secured property has declined, second mortgagees have a financial incentive to delay and obstruct a first mortgage foreclosure. Moreover, in transactions involving the possible securitization of senior mortgage financing, rating agencies have been particularly concerned about the risks posed by subordinate mortgages. As a result, more and more first mortgagees have insisted that borrowers not encumber the secured property with subordinate mortgages.

The typical mezzanine borrower will therefore be an entity which requires emergency funding to complete a project or transaction, but cannot obtain further secured financing. The borrower must also be willing to accept a mezzanine lender's return rate of 20-30 percent on their investment. Accordingly, a prominent capital management group has listed the following criteria for an attractive mezzanine financing candidate:

a. Strong historical and sustainable financial performance with good margins;
b. Little customer concentration;
c. Strong brand name;
d. Compelling product or service;
e. Excellent financial controls;
f. Industry with limited cyclicality, technology risk, and regulatory volatility;
g. Management with depth and experience, a meaningful personal investment, and an agreed-upon exit strategy.[46]

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[46] *See* Bailey S. Barnard, *Mezzanine Financing Demystified*, Caltius Capital Mgmt., *available at* http://www.caltius.com/pdfs/DemistMezz.PDF#search='mezzanine%20financing' (last visited Jul. 12, 2006).

3. Why do they use it?

a. Benefits to borrower.

The benefits of the mezzanine arrangement to the borrower are obvious. If a borrower needs a relatively quick infusion of cash to complete an important and potentially profitable project or transaction, mezzanine financing may be its only option. Given that the opportunities for adding subordinate mortgages on to existing business assets have largely disappeared, the mezzanine financing option becomes that much more attractive.

For a business in such a situation, the only other option may be to take on another partner or outside investor to supply the needed capital. The problem with that option is that the controlling partner(s) will in many cases be forced to cede some of that control to the outside investor as part of the price of the new capital. In addition, the existing partners' equity in the venture may well be diluted to an unacceptable level.

In the typical mezzanine financing arrangement, the mezzanine lender will only take a minority ownership position, and will seek only board observation rights rather than actual board representation. The mezzanine lender will often reserve the right to gain board representation only if matters do not go as planned – i.e. the project or transaction falls through – in order to ensure that its investment is repaid. The recent trend in this area, especially where large institutional lenders are involved, is for mezzanine lenders to insist upon more and more control over the borrower's operations. Such agreements will vary widely depending on the specific circumstances of the parties, and their relative bargaining positions.

The lender will almost always insist upon the right to negotiate intercreditor arrangements with any future lenders utilized by the borrower. This has the effect of making the process more costly and time-consuming, and may scare away future lenders.

However, in the final analysis the features of mezzanine financing thus enable mezzanine borrowers to obtain needed cash while minimizing the negatives associated with emergency borrowing.

b. Benefits to lender.

The most obvious benefit to a mezzanine lender is the ability to collect a relatively high interest rate on the money lent. The trade-off is that the lender takes on a higher degree of risk than a traditional mortgage lender, as its investment is not secured by any tangible property. This risk can be minimized in several ways.

First, the mezzanine lender should only offer such financing to borrowers which are either already in a sound financial condition, or in the process of closing a project or transaction that will almost certainly result in the repayment of the loan. Mezzanine lenders get into the most trouble when they lend money to entities which the lender should have known from the outset probably could not satisfy the loan.

The second protective measure the mezzanine lender can take is to gain as much control over the ongoing project or transaction as is feasible. This will ensure that the relevant business is brought to fruition in a manner consistent with the interests of the mezzanine lender.

Finally, the mezzanine lender should obtain adequate assurances, through agreements with both the borrower and the mortgage lender, that the agreed-upon portion of the proceeds from the project or transaction go to the mezzanine lender, and not the mortgage lender and/or other parties. These agreements will vary widely depending on the respective goals and bargaining positions of the parties.

In the end, so long as the mezzanine lender takes adequate precautions against borrower default, the mezzanine financing arrangement can be an attractive option for a lender seeking to maximize the return on its investment dollars.

4. Example in the construction industry.

Mezzanine financing is commonly used in construction situations. When a construction company gets a loan to build a structure, it is often not required to make any payments until the building is scheduled to be completed. For a wide variety of reasons, a construction project may not be completed on schedule. As a result, on the date that the company must begin to pay off the initial loan, because of the delays, the company will be unable to collect any money from the sale or lease of the building. Traditional lenders in this situation may be unwilling to grant extensions, choosing instead to rely on their foreclosure remedy to recoup their losses.

A construction company in this situation may be forced to rely on mezzanine financing to bridge the gap between the time when the initial loan comes due and the time when it can finish the building and begin to collect money on it. If the building is near to completion, or has the potential to be a big money-maker, mezzanine lenders may be willing to take a chance on the project.

If the construction company is willing to pay high interest rates to the lender, and is able to negotiate an agreement where it retains most of the operational control over the project, mezzanine financing may be a viable option, if only to avoid the financial disaster which would result from foreclosure.

Section III Appendix

Exhibit A – Sample Construction Loan Agreement

CONSTRUCTION LOAN AGREEMENT

This Construction Loan Agreement (“Agreement”) is entered into this _____ day of _________, 2005 by and among ________ (“Lender”) and _______(“Borrower”). Notwithstanding any other terms or conditions contained in the Loan Agreement, the following terms and conditions shall control during the period of disbursement of the Loan Amount in the amount of $ X.

ARTICLE 1
DEFINTIONS

For purposes of this Agreement, the following terms shall have the following meanings:

1.1 "Contractor" shall mean the contractor as determined by Borrower.

1.2 "Disbursing Agent" shall be the Lender or Title Company as determined, by Lender.

1.3 "Land" shall mean the real property identified on _____ (document) located in _________, Minnesota, of the Mortgage executed by ______, as Mortgagor, ______ as Mortgagee.

1.4 "Loan Agreement" shall mean the Loan Agreement executed between Borrower and Lender of even date and of which this Exhibit "A" is a part.

1.5 "Improvements" shall mean the construction of improvements upon the Land by Borrower in accordance with the Plans and Specifications.

1.6 "Plans and Specifications" shall mean those drawings and specifications for the Improvements and approved by the Lender.

1.7 "Project" shall mean the Land, Improvements, and all fixtures, as they may at any time exist.

1.8 "Collateral Documents" shall include the Loan Documentation as identified in the Loan Agreement and the additional documentation identified in paragraph 2 of the Loan Agreement.

1.9 "Construction Documents" shall mean the following documents relating to the Project, all of which shall be in form and substance acceptable to Lender:

(a) All construction plans and specifications and contracts.

(b) Certificates of Builders' Risk Non-Reporting Completed Value Form Insurance.

(c) Certificate of Insurance against loss by fire, builder’s risk and other risks and hazards generally covered by extended endorsements for full replacement cost of all improvements in an amount acceptable to Lender, containing a replacement cost endorsement with Lender listed as mortgagee and lender loss payee.

(d) Certificate of general public liability insurance in an amount acceptable to Lender, containing a replacement cost endorsement with Lender listed as additional insured.

(e) A signed copy of the construction contract executed by Borrower and the Contractor and a photocopy of each subcontract, if any, entered into by the Contractor and each subcontractor.

(f) All building permits and such other evidence as Lender may require to establish that all necessary building, zoning, planned unit development, subdivision, platting, environmental protection and land use permits and approvals for the Project have been obtained, and that the Project as constructed will comply in all respects with all applicable building, zoning, planned unit development,. subdivision, platting, environmental protection and land use ordinances, laws, regulations and requirements, including, but not limited to, an opinion of counsel for the Borrower pertaining to such matters in form and substance acceptable to Lender.

(g) Environmental reports as may be required by Lender.

1.11 "Construction Costs" shall mean all direct costs paid to acquire, construct and/or complete the Land and Improvements, including, but not limited to, costs for acquisition of permits and licenses required by the municipality in which the Project is located, site preparation costs, architectural fees, engineering fees, costs of acquisition and installation of the fixtures and all costs of labor, material and services paid or incurred by Borrower.

1.12 “Draw Request” shall mean a signed cover letter from Borrower, indicating the amount requested to be disbursed and an AIA draw request form properly executed and notarized, with certification by Borrower, Borrower’s contractor and Borrower’s architect, stating that such draw requests are for reimbursement of actual costs incurred for the completion of the Project.

1.13 "Loan and Carrying Charges" shall mean all commitment fees to Lender, brokerage fees, interest charges, service fees, attorneys' fees and disbursements (including attorneys for Lender), title insurance fees and charges, recording fees, registration taxes, real

estate taxes, special assessments, insurance premiums and utility charges incurred by Borrower in the construction of the Project.

1.14 "Title Company" and/or "Title" shall mean Land Title, Inc.

1.15 "Total Project Costs" shall mean the total of all Construction Costs and Loan and Carrying Charges.

1.16 "Owner Equity" shall mean the Total Project Costs less the amount of the Loan.

1.17 "Completion Date" shall mean twelve (12) months from the date hereof.

1.18 "Loan" shall mean the Loan Amount as defined in the Loan Agreement to the extent Lender advances are made under the provisions hereof.

ARTICLE 2
ADVANCES AND DISBURSEMENTS

2.1 Upon written request by Borrower, made no more often than monthly, Lender shall within ten (10) days thereafter, advance to Disbursing Agent amounts certified to be currently payable by Borrower for Total Project Costs pursuant to a Draw Request in form and substance satisfactory to Lender. All Construction Costs shall have been approved in writing by the architect. All Loan and Carrying Charges shall be approved by Lender, and to the extent payable to Lender need not be disbursed to Disbursing Agent but may be immediately credited by Lender. Disbursing Agent shall disburse all funds advanced to it under this Agreement in such manner as it shall deem appropriate to perform its obligations under this Agreement, Provided, however, if Disbursing Agent and/or Title Company shall, in its opinion be unable to perform its obligations hereunder, the Disbursing Agent shall have the right to refuse, to disburse said advance. In the event Disbursing Agent shall fail to disburse any advance within five (5) business days after the date of advance, Disbursing Agent shall, upon request of Lender or Borrower, return said advance to Lender and interest on such advance shall abate from and after the date of such return, Any amounts advanced to Disbursing Agent and returned by Disbursing Agent to Lender shall not be deemed to have been advanced under the Collateral Documents.

2.2 Disbursing Agent shall not disburse any advance hereunder unless Title Company shall insure Lender as to the priority of the Mortgage over all claims for mechanic's liens against the Project and against any changes in the status of title to the Project from that shown in the original title insurance policy to Lender to the full extent of all sums advanced to Title Company hereunder. Within three (3) business days of the date of each disbursement, Title Company shall deliver to Lender such written documents if any, as may be necessary to confirm Title Company's commitment to insure Lender against mechanic's liens and any changes in the status of title from that shown in the original title insurance policy issued to Lender by Title Company. Disbursing Agent shall not disburse any advance hereunder unless Disbursing Agent and Lender have received from Borrower and Title Company mechanic’s lien releases for all preceding

draws and updates to Lender's title policy confirming that there are no intervening liens with respect to the Project.

2.3 If any Loan and Carrying Charges are unpaid, Lender shall be, and hereby is, authorized to advance from the proceeds of the Loan, the total amount of such Loan and Carrying Charges (whether or not a Draw Request has been submitted by Borrower) and the same shall be deemed to be an advance of the proceeds of the Loan under this Agreement in the same manner and with the same effect as if advanced under the provisions of paragraph 2.1 hereof.

2.4 All sums advanced and disbursed hereunder shall be secured by the Collateral Documents.

ARTICLE 3
CONDITIONS PRECEDENT TO ADVANCES

3.1 The following events shall be conditions precedent to the first advance under this Agreement:

(a) Borrower shall deliver, without expense to Lender, copies of each of the Collateral Documents and the Construction Documents, each to be duly executed to the extent required by Lender. The Collateral Documents required by Lender to be filed shall have been filed, without expense to Lender, and all filing fees, charges, expenses and taxes (including, but not limited to, mortgage registration tax) shall have been paid by Borrower.

(b) There shall be no default under the terms of this Agreement or any of the Collateral Documents.

(c) _____ shall have issued to Lender its ALTA policy of title insurance in the amount of $ X insuring the Mortgage to be a first lien an the Project without exception for the possibility of mechanic's liens, but subject to the Permitted Encumbrances in the Mortgage.

(d) Borrower shall have paid so much of the Owner Equity into the Project as Lender shall have required to be paid prior to the first advance, and Borrower shall have delivered proof of such payment reasonably satisfactory to Lender.

(e) Borrower shall deliver to Lender financial statements acceptable to Lender.

(f) Borrower shall have furnished to Lender an appraisal by a registered appraiser acceptable to Lender showing a value after completion acceptable to Lender.

3.2 The following events shall be conditions precedent to each subsequent advance under this Agreement:

(a) There shall be no default under the terms of this Agreement or any of the Collateral Documents.

(b) The title to the Project shall be approved in all respects by Lender. In the event any lien for work or services performed on the Project or material delivered thereto has been filed, Title shall, before making any disbursement under this Agreement, notify Lender of such fact. Upon written request from Lender, Borrower shall immediately satisfy of record any such lien; provided, however, that Borrower shall not be required to pay, discharge or satisfy any such lien so long as Borrower shall in good faith contest the same or the validity thereof by appropriate legal proceedings which shall operate to prevent the collection thereof and the sale of the Project, or any part thereof, to satisfy the same, and provided that the Borrower shall have given to Lender such reasonable security as may be demanded by Lender to insure payment and prevent any sale or forfeiture of the Project by reason of such nonpayment. Any such contest shall be prosecuted with due diligence and Borrower shall promptly after final determination thereof pay the amount of any such lien as so determined, together with all interest and other costs which may be payable in connection therewith.

(c) As of the date immediately prior to any advance, the total amount of the unadvanced proceeds of the Loan shall be sufficient, in Lender's opinion, to complete the Project. To the extent that the total amount of the unadvanced proceeds of the Loan shall be insufficient, in Lender's opinion, to complete the Project, Borrower shall immediately deposit with Lender, an amount equal to such deficiency as additional Owner Equity and such additional Owner Equity shall be disbursed prior to the disbursement of any further advance or advances of Loan proceeds under this Agreement.

(d) Prior approval by the Lender shall be required for any and all change orders. The Borrower shall provide cash for any change order which would result in any increase cost of construction over the accepted contracts, plus bids and specifications.

(e) Provide Lender with copies of any purchase agreement for the Property as they are entered into between Borrower and a third party.

3.3 The following documents shall, if requested by Lender, be delivered by the Completion Date, and if requested by Lender, the delivery of each and every one of these documents shall be a condition precedent to the final advance under this Agreement.

(a) All certificates of occupancy, subdivision ordinance variances, environmental impact statements, pollution control permits and such other licenses, permits and other evidence as Lender may reasonably require to show compliance with all legal requirements for occupancy of the Improvements,

(b) Written acknowledgment from the tenant occupying the Project that it has accepted the Project, including the Improvements.

(c) A recertification of the appraisal, in form and substance acceptable to Lender, showing a value of the Loan Property as improved in an amount acceptable to Lender.

ARTICLE 4
COVENANTS, WARRANTIES. REPRESENTATIONS AND AGREEMENTS OF BORROWER

Borrower covenants, warrants, represents and agrees:

4.1 That all advances under this Agreement shall be used solely to pay Project Costs. That the: Project does and shall comply with all applicable ordinances, regulations and laws of governmental departments and agencies having jurisdiction and does not and shall not violate any private restrictions or covenants or encroach upon or interfere with easements affecting the Land. That Borrower will carry on the construction of the Project in accordance with the Plans and Specifications continuously, diligently and with reasonable dispatch, and in a good and workmanlike manner, and complete the same (except landscaping if weather conditions are adverse), on or before the Completion Date. Borrower shall not permit any changes to be made in the Plans and Specifications except within parameters as may be approved by Lender, which consent shall not be unreasonably withheld.

4.2 To keep, perform, enforce and maintain in full force and effect all of the terms, covenants, conditions and requirements of this Agreement, the Collateral Documents and the Construction Documents; not to materially amend, cancel, change, terminate, supplement or waive any of the terms, covenants or conditions, of the Collateral Documents or Construction Documents without the consent of Lender; and to execute such amendments, modifications and extensions of the Collateral Documents and the Construction Documents as may reasonably be requested by Lender,

4.3 Upon the demand of Lender for reasonable cause, from time to time and at any time, to deliver to Lender updated and recertified copies of the Collateral Documents and the Construction Documents. Why are these needed?

4.4 To create, permit to be created or allow to exist, no liens, charges or encumbrances on the Project.

4.5 Not to assign this Agreement or any interest herein or all or any part of any advances to be made hereunder except as herein expressly set forth.

4.6 To pay to Lender, upon demand, all filing fees, engineering fees, including those of the inspector, mortgage registration tax, and all other out-of-pocket expenses, if any, directly incurred and from time to time hereafter incurred by Lender in connection with the Loan, together with attorneys' fees incurred in preparing this Agreement and any other Loan closing documents, revising the same, advising the Lender concerning the Loan and enforcing the terms and conditions of this Agreement or any document herein referred to, or in exercising any of the rights granted to Lender herein or in any documents herein referred to, whether suit be brought or not. Such expenses to be paid by Borrower shall not be refunded even if this Agreement is

canceled and Borrower shall yet remain obligated to pay such out-of-pocket expenses incurred by Lender in connection with the Loan notwithstanding cancellation hereof.

4.7 To observe and comply with and to cause all contractors to observe and comply with the reasonable requirements of Lender and Title promptly and fully.

4.8 To set up and maintain accurate and complete books, accounts and records pertaining to the project in a manner reasonably acceptable to Lender. Lender, Title and Inspector, and their representatives, shall have the right at all reasonable times to inspect, examine Line and copy all books and records of Borrower relating to the Project, and to enter and have free access to the Project and to inspect all work done, labor performed and material furnished in or about the Project. Notwithstanding the foregoing, Borrower shall be responsible for making inspections of the Project during the course of construction and shall determine to its own satisfaction that the work done or materials supplied by all contractors have been properly supplied in accordance with the applicable contract. Borrower will hold Lender harmless and Lender shall not have any liability or obligation of any kind to Borrower or creditors of Borrower in connection with any defective, improper or inadequate workmanship or materials. Upon Lender's request, Borrower shall replace or cause to be replaced any such work or materials. Any inspections made by Inspector are for the sole benefit of Lender and neither Borrower nor any creditor of Borrower shall be entitled to rely on such inspections.

ARTICLE 5
DEFAULT AND REMEDIES

5.1 The occurrence of any of the following events, each herein called an "Event of Default", shall constitute a default under this Agreement:

> **(a)** Borrower shall fail to make any payment required under this Agreement or under any of the Collateral Documents within ten (10) days of notice from Lender of failure to make payment when due.
>
> **(b)** Borrower shall fail to observe and perform any other covenant, condition or agreement on its part under this Agreement and/or any Loan Documents to be performed.
>
> **(c)** Any representation or warranty made by the Borrower herein, or in any certificate or document furnished pursuant hereto, proves untrue in any material respect in the reasonable opinion of Lender,
>
> **(d)** Borrower shall file a petition in bankruptcy pursuant to any present or future Federal bankruptcy act or under any similar Federal or state law, or shall be adjudicated a bankrupt or insolvent, or shall make an assignment for the benefit of its, creditors, or shall admit in writing its inability to pay its debts generally as they become due; or a petition or answer proposing the adjudication of Borrower as bankrupt under any present or future Federal bankruptcy act or any similar Federal or state law shall be filed in any court and such petition or answer shall not be discharged or denied within

ninety (90) days after the filing thereof; or a receiver or trustee of Borrower or of the Project shall be appointed in any proceeding brought against Borrower and shall not be discharged within ninety (90) days after such appointment, or Borrower shall consent to or acquiesce in such appointment; or the estate or interest of Borrower in the Project or a part thereof shall be levied upon or attached in any proceeding and such process shall not be vacated or discharged within sixty (60) days after such levy or attachment.

(e) The Project is materially damaged or destroyed by fire or other casualty and the loss is not adequately covered by Owner Equity or insurance proceeds actually collected or in the process of collection, and the Project is not being restored as provided in Mortgage.

(f) At the time any advance is requested by Borrower the title to the Project is not reasonably satisfactory to Lender or Title, regardless of whether the lien, encumbrance or other question existed at the time of any prior advances, unless such lien is being contested. pursuant to Section 3.2 (b) hereof.

(g) Borrower sells, assigns or conveys (whether by Contract for Deed or otherwise), leases or otherwise transfers all or any part of the Project (regardless of whether the buyer, assignee or transferee assumes the obligations of the Borrower hereunder or takes said premises subject to said obligations) without obtaining, in each instance, the written approval of Lender.

5.2 In the event of the occurrence of an Event of Default, the Lender, at its option, in addition to any other remedies to which it might by law be entitled, shall have the right:

(a) To refrain from making any advance under this Agreement, but Lender may make advances after the happening of any such event without thereby waiving the right to refrain from making other or further advances or to exercise any of the other rights Lender may have.

(b) To enter into possession of the Project and perform any and all work and labor necessary to complete all or any part of the Improvements contemplated by this Agreement and to do all things necessary or incidental thereto.

(c) To perform such other acts or deeds which may be necessary to cure any default existing under this Agreement or under the Collateral Documents or the Construction Documents and, to this end, it is hereby agreed as follows:

(i) All sums expended by Lender effectuating its rights under this Agreement shall be deemed to have been paid to the Borrower hereunder and shall become a part of the Borrower's indebtedness to Lender under this Agreement and be secured by the Collateral Documents, whether or not such sums, when added to all previous advances made hereunder, exceed the Loan.

(ii) Borrower hereby constitutes and appoints Lender its true and lawful attorney-in-fact with full power of substitution upon default either in the name of Lender or in the name of Borrower: (1) to complete or cause to be completed all or any part of the Project; to use the Plans and Specifications; to make such additions and changes and corrections in the Plans and Specifications which Lender shall deem necessary or desirable to complete all or any part of the Project; to collect and use any funds of Borrower, including any balance which may be held on deposit by Title and/ or Lender, to use any funds which may remain unadvanced under this Agreement; to employ such contractors, subcontractors, agents, architects and inspectors and enter into such contracts and arrangements as shall be required for such purposes; to pay, settle or compromise all existing bills and claims which may be liens against the Project or as may-be necessary or reasonably desirable for the completion of the work or clearance of title; examine and execute all applications and certificates in the name of Borrower; to prosecute and defend all actions or proceedings in connection with the construction work on, or any other matter relating to, the Project and to do any and every act which Borrower might do in its own behalf, (2) to enforce by any means that Lender then deems necessary or advisable all of the terms, covenants and conditions of the Collateral Documents and Construction Documents; (3) to perform each of the terms, covenants and conditions to be kept and performed by Borrower under the Collateral Documents and Construction Documents; (4) without limiting the foregoing, to perform each of the terms, covenants and conditions to be kept or performed by Borrower under this Agreement, and any of the Collateral Documents and the Construction Documents; and (5) to do all things that Lender then deems necessary or advisable, including without limitation the execution of instruments in the name of Borrower or as attorney-in-fact for Borrower, for the purpose of carrying out the powers enumerated in (1), (2), (3) and (4) of this Subparagraph (ii).

(iii) The powers herein granted to Lender shall be deemed to be powers coupled with an interest and the same are irrevocable.

(e) Terminate its obligations pursuant to this Agreement.

(f) Bring appropriate action to enforce such performance and the correction of such failure or default.

(g) To declare the entire unpaid principal of the Loan Note and all accrued interest thereon, together with all sums advanced hereunder or under any Collateral Documents, immediately due and payable without notice.

(h) To foreclose the Mortgage or realize upon any other security now or hereafter securing the Loan Note.

5.3 No right or remedy by this Agreement or by any document or instrument delivered by Borrower pursuant hereto, conferred upon or reserved to Lender shall be or is

intended to be exclusive of any other right or remedy, and each and every right and remedy shall be cumulative and in addition to any other right or remedy now or hereafter existing at law or in equity or by statute.

5.4 Except as Lender may hereafter otherwise agree in writing, no waiver by Lender of any breach by or default of Borrower, of any of its obligations, agreements or covenants under this Agreement shall be deemed to be a waiver of any subsequent breach of the same, or any other obligation, agreement or covenant, nor shall any forbearance by Lender to seek a remedy for such breach be deemed a waiver of its rights and remedies with respect to such breach, nor shall Lender be deemed to have waived any of its rights and remedies unless it be in writing and executed with the same formality as this agreement,

ARTICLE 6
MISCELLANEOUS

6.l All notices provided for herein shall be in writing and shall be deemed to have been given when delivered personally or when deposited in the United States Mail, registered or certified mail, postage prepaid, addressed as follows:

If to Borrower at: Address

If to Lender at: Address

or addressed to any such party at such other address as such party may hereafter furnish by notice to the other parties.

6.2 This Agreement shall be construed according to the laws of the State of ______.

6.3 Lender shall have the right, subject to applicable ordinances, to erect a sign of reasonable size in a prominent position on the Land at its own expense indicating to the general public that Lender is providing the financing for the Project, Borrower agrees that said sign may remain in place throughout the period of construction after which it will be removed by Lender. It is understood that the sign shall remain the property of Lender.

6.4 If any term, condition or provision of this Agreement or the application thereof to any person or circumstance shall, to any extent, be held to be invalid or unenforceable, the remainder thereof and the application of such term, provision and condition to persons or circumstances other than those as to whom it shall be held invalid or unenforceable shall not be affected thereby, and this Agreement and all the terms, provisions and conditions hereof shall, in all other respects, continue to be effective and to be complied with to the full extent permitted by law.

6.5 In the event of damage or destruction to the Project or in the event of the taking of a part of the Project by eminent domain, and Borrower is restoring the Project in accordance with the provisions of the Mortgage, or in the event of delays caused by acts of arbitration, fires, strikes, legal acts of public authorities, war, delays or defaults by public or private carriers, acts

of God or other causes beyond the control of Borrower, the Completion Date shall be extended a maximum of ninety (90) days.

IN WITNESS WHEREOF, the parties hereto have executed this Agreement as of the day and year first above written.

LENDER:	**BORROWER:**
______________________________	______________________________
By:	By:
Its:	Its:

The undersigned hereby agrees to act as Disbursing Agent in connection with the foregoing Agreement.

____
By: ___________________________
Its: ___________________________

Exhibit B – Sample Letter of Credit

IRREVOCABLE LETTER OF CREDIT NO. _____

Date: ___________________, 20___

____
____
____

Dear ____________________:

_______________________ (the "Issuer") hereby establishes a IRREVOCABLE LETTER OF CREDIT, numbered as indicated above, and effective as of the date listed herein above ("Effective Date"), in favor of _________________________________, (the "Applicant") at the request and for the account of ____________________________, a Minnesota ____________________________, ("Developer") in the amount of and not to exceed ___________________ ___________________ Dollars ($____________________) as such amount is decreased as provided below, available to you by your sight draft or drafts upon us in connection with the completion of certain improvements which shall be specifically identified on Exhibit A, attached hereto and incorporated herein by reference for the subdivision known as "_____________________", as described in the Developer Agreement dated ________________________, 2005, between the Applicant and the Developer ("Improvements").

(Check which is applicable)

☐ The term of this IRREVOCABLE LETTER OF CREDIT shall commence on the Effective Date and shall terminate on the ___ day of _____________, 200___, unless as may be otherwise provided hereinafter.

☐ The term of this IRREVOCABLE LETTER OF CREDIT shall commence on the Effective Date and shall terminate one (1) year from the Effective Date hereof.

Each draft drawn under this IRREVOCABLE LETTER OF CREDIT must be accompanied by:

A. The original of the IRREVOCABLE LETTER OF CREDIT.

B. A notarized statement executed by the Applicant Administrator stating that the Developer is in default of the Development Agreement, the Developer has failed to complete the Improvements in accordance with the terms of the Development

Agreement; and the Applicant is entitled to draw upon the IRREVOCABLE LETTER OF CREDIT.

Each draft drawn under this IRREVOCABLE LETTER OF CREDIT must:

1. Be signed on behalf of the Applicant by the Applicant Administrator of his/her designed;

2. Be in an amount required to cure the default by the Developer to complete the Improvements, which amount shall not exceed $________________________.

3. Bear on it face the clause "DRAWN UNDER IRREVOCABLE LETTER OF CREDIT NO. _____, DATED __________________________, 200___.

4. Be presented for payment during regular business hours at _____________________, ________________, no later than ______p.m. on ______________________, 20___, at which time this IRREVOCABLE LETTER OF CREDIT shall expire, unless as may be otherwise provided hereinafter.

We shall have seven (7) days to examine documents tendered for presentment. The amount of the IRREVOCABLE LETTER OF CREDIT shall be reduced by the amount of the estimated cost of the work completed as each portion of the Improvements is completed and paid for, and the Applicant Engineer approves in writing such reduction. Each drawing hereunder shall reduce by the amount of such drawing the amount available under this IRREVOCABLE LETTER OF CREDIT.

We hereby agree that drafts drawn under and presented in conformity with the terms of this IRREVOCABLE LETTER OF CREDIT will be duly honored upon presentation and the expiration of the review period, not to exceed seven (7) days.

Except as otherwise expressly stated, this IRREVOCABLE LETTER OF CREDIT is subject to the Uniform Customs and Practice for Documentary Credits (1993 Revision). This IRREVOCABLE LETTER OF CREDIT shall be deemed to be a contract made under the laws of the State of Minnesota, and, as to matters not governed by the Uniform Customs, shall be governed by and construed in accordance with the laws of the State of Minnesota, including the Uniform Commercial Code as in effect in the State of Minnesota. Any dispute arising hereunder shall be brought in the District Court of _______________ County, Minnesota.

This IRREVOCABLE LETTER OF CREDIT is not transferable or assignable and is not issued for the benefit of any third party claimant.

We shall not be called upon to resolve issues of fact or law between the Applicant and the Developer.

This IRREVOCABLE LETTER OF CREDIT sets forth in full the terms of our undertaking, and such undertaking shall not in any way be modified, amended or amplified by reference to any note, document, instrument or agreement referred to herein or in which this IRREVOCABLE LETTER OF CREDIT is referred to or to which this IRREVOCABLE LETTER OF CREDIT relates and any such reference shall not be deemed to be incorporated herein by reference to any note, document or agreement.

(Check which is applicable)

☐ This IRREVOCABLE LETTER OF CREDIT shall not be amended, modified or waived as applicable.

☐ This IRREVOCABLE LETTER OF CREDIT shall not be amended, modified or waived as applicable, without the express written consent of the Borrower, Lender and Applicant.

(Check which is applicable)

☐ This IRREVOCABLE LETTER OF CREDIT shall not be extended beyond its term.

☐ This IRREVOCABLE LETTER OF CREDIT shall be automatically extended without amendment for one (1) year from the expiration date, or a future expiration date, unless ninety (90) days prior to any expiration we notify you by registered mail that we elect not to renew this IRREVOCABLE LETTER OF CREDIT for such an additional period. In the event we decline to renew this IRREVOCABLE LETTER OF CREDIT, you may draw hereunder on or prior to the then relevant expiration date, up to the full amount then available hereunder, against your sight draft(s) on us, bearing the number of his IRREVOCABLE LETTER OF CREDIT.

BY:__________________________
(Name)

TITLE: ______________________